



VERITAS PRIVATE CLIENT LETTER

October 2009

On the fifteenth of December 1692, the House of Commons resolved itself into a Committee of Ways & Means... Montague proposed to raise a million by way of a loan: the proposition was approved... The principle appears to have been popular with all parties. The moneyed men were glad to have a good opportunity of investing what they had hoarded. The landed men, hard pressed by the load of taxation, were ready to consent to anything for the sake of present ease.

It was certain that the eighteenth century would be far advanced before the debt would be finally extinguished... The rate of interest was to be ten percent till the year 1700, and after that seven per cent.

Such was the origin of that debt which has since become the greatest prodigy that ever perplexed the sagacity and confounded the pride of statesmen and philosophers. At every stage in the growth of that debt it has been seriously asserted by wise men that bankruptcy and ruin were at hand. Yet still the debt kept growing; and still bankruptcy and ruin were as remote as ever. When the great contest with Lewis the Fourteenth was finally terminated... the nation owed about fifty millions... Then came the war of Austrian succession; and the debt rose to eighty millions... Soon war again broke forth; and, under the energetic and prodigal administration of the first William Pitt, the debt rapidly swelled to a hundred and forty millions. Men of theory and men of business almost unanimously pronounced that the fatal day had now really arrived. David Hume, one of the most profound political economists of his time, declared... "Better for us to have been conquered by Prussia or Austria than to be saddled with the interest of a hundred and forty millions." And yet this great philosopher had only to open his eyes and to see improvements all around him, cities increasing... houses better furnished, richer wares exposed to sale in statelier shops... He had indeed only to compare the Edinburgh of his boyhood with the Edinburgh of his old age. His prediction remains to posterity a memorable instance of the weakness from which the strongest minds are not exempt.

History of England, Part 4, Lord Macaulay, 1855.

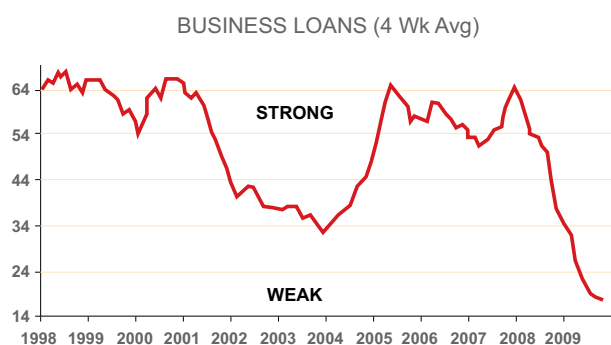
Equity markets have bounced robustly from March's Armageddon sell-off, although both the FT All Share and the S&P 500 equity indices are only back to last September's pre-Lehman levels. Financial meltdown has been avoided and liquidity conditions have improved significantly. Western economies appear to be levelling off as the huge stimulus packages around the world gain traction and inventories are re-built. The numbers are helped by year-on-year comparisons getting easier.

Markets are in a sweet spot: policy tightening in major Western economies is a way off, inflation is not an immediate concern, bond markets are benign. Is this sustainable? Is "the patient", the world economy, out of hospital – or merely out of intensive care?

The fact is that the Authorities have not tackled the root cause of the problem, namely, excessive debt levels in Western economies. Interest rates have been cut to address the issue of repayment, but in aggregate the total stock of debt has grown as governments have borrowed to fund stimulus packages. IOUs have merely been taken from the private sector's pocket and tucked into the public sector's. At some point they will return to the private sector via tax increases. The healing process will become a headwind for recovery.

The numbers may say recovery but there is widespread evidence of its continuing fragility.

The IMF's Global Financial Stability Report anticipates US bank losses in the next 18 months of a further \$1.5 trillion on top of the \$1.3 trillion already disclosed. One-third of the total will have originated from toxic assets; two-thirds will arise out of loan portfolios hit by the recession. Although the Federal Reserve ("the Fed") has vastly increased the banks' reserves, they are hoarding the money, so that the Fed's loose monetary policy is not resulting in more loans.



Source: ISI Company Survey Report, 2 October 2009

US retailers have reported a sharp shift from credit cards to debit cards and cash over the past year, symptomatic of the damage to many consumers' balance sheets from

the declines in home equity and 401k retirement plans. Although house prices seem to be stabilising, high unemployment is a restraint.

In Germany, Angela Merkel, riding high on her victory, faces slowing wage growth and high unemployment. Exports are faltering.

In the UK public sector net borrowing is projected to reach a massive 12.4% of GDP in the current financial year and the public sector debt ratio to rise to 76% by 2013.

It would seem that the patient is out of intensive care but still in hospital.

Taps on full

However, as Lord Macaulay points out (front cover), this is not the first time the UK has faced seemingly ruinous debt levels. And Samuel Brittan reminds us¹ that in the early Victorian era the public sector debt ratio was 200%, it almost reached that again in the early 1920s and in 1956 under Harold Macmillan's Chancellorship it was 150%. In each case the debt was gradually reduced without any "heroic gesture".

And there is one bank still willing to lend: the central bank. The economy will find it difficult to cope with the withdrawal of stimulus. The Authorities will consequently clearly err on the side of keeping the liquidity taps turned on full.

In addition, American investors were still holding \$3.5 trillion in money markets funds in September, equal to 73% of the S&P500 Index companies' net assets (source: Bloomberg).

High liquidity levels and low interest rates are clear positives for equities, but, against this fragile economic backdrop, volatility is to be expected.

We believe that equities will deliver better returns than lower-risk assets over our time horizon of five years plus. Bonds have been in a multi-decade bull market as inflation has fallen from double-digit levels, with the final fall in yields induced by the flight to safety of the credit crisis overlain by the Authorities flooding the system with liquidity.

Assuming we do not follow the Swedish example of negative interest rates (the ultimate deterrent to saving and personal financial responsibility), yields have little scope to fall further. UK Gilts and US Treasuries carry the additional burden of rising sovereign risk given these countries huge fiscal deficits, while the large stimulus packages may prove inflationary a few years' hence. We would be astonished if returns on Gilts and Treasuries kept pace with those on equities going forward.

Economic fragility arising out of excessive debt levels is not the only headwind facing investors. Another example is demographics, the much publicised “ageing of the population”. The beneficial effects on the healthcare sector are well documented (and indeed a theme in Veritas portfolios), but there is less focus on other aspects of this phenomenon. The stagnation and subsequent decline of the working age population lowers real GDP growth. This is already clearly evident in Japan. The decline in the workforce is just commencing in the EU and it will peak in the US around 2020. This heralds a drawdown in savings while the pressure on fiscal deficits will escalate as Baby Boomers become eligible to claim Social Security (age 62) and Medicare (age 65). Over-65s are 13% of the population now, but this will reach 20% by 2030.

In Japan centenarians have for many years received a congratulatory 100 gram silver sake cup. This year, reflecting the rise in the number of people celebrating their 100th birthday, the cups will be made using only 65 grams of silver...

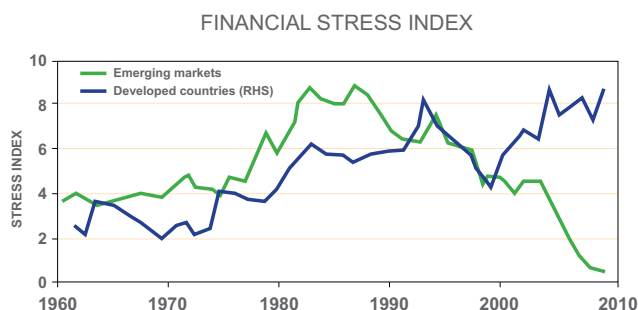
Rifles to the ready

Against this difficult backdrop with its multiple challenges, investors seeking to protect and grow their capital will benefit from a rifle-shot approach to stock selection. This is vintage Veritas. In our quest for real returns for our clients, we focus on avoiding the headwinds and benefiting from tailwinds by searching out well managed businesses protected by a moat and generating sustainable, growing free cash flow - with the shares purchased at a reasonable valuation.

Our core conviction theme of “strong survivors” permeates all our holdings – companies that we believe will emerge from the current challenging environment in a robust position with earnings and dividends continuing to come through.

If we are to deliver real returns ahead of inflation however, we will need in addition to find areas of “strategic growth” as a tailwind for profits and cash flows. Here our list is still headed up by Asia.

The graph vividly illustrates the key secular difference between the West and the Third World. UBS have created a “financial stress index”, made up of net external debt, the fiscal balance, the increase in credit / GDP and the external current account balance. Financial stress has been rising steadily in developed countries, particularly since the 1990s – while in emerging countries it has fallen sharply.



Source: UBS

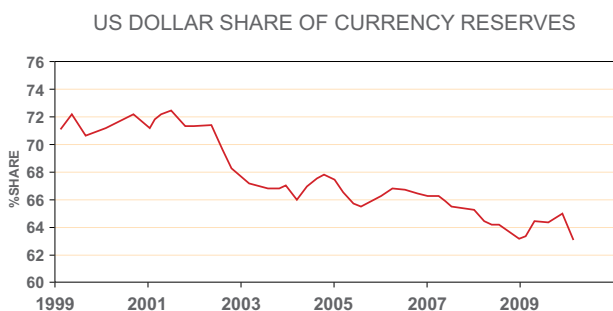
We view Asia as the most attractive of the emerging continents, with its high savings ratios and work ethic.

As China celebrated the 60th anniversary of the founding of the People’s Republic on 1st October, the evidence of the restoration of the Middle Kingdom continues to mount. The Bank of China, the country’s third largest lender by assets, is unveiling a range of Swiss-based funds denominated in renminbi. They are aimed at wealthy Chinese investors desiring global exposure, as well as giving international investors their first opportunity of a Swiss-registered renminbi-denominated share class. Beijing is seeking to internationalise the role of the renminbi.

The Bank of China has started offering mortgages to credit-starved British borrowers at rates that undercut many of the deals available from established UK lenders.

Renminbi-denominated sovereign bonds are being sold in Hong Kong, offering a higher coupon than available on the mainland to ensure the issue’s success. Again the purpose is to elevate the international status of the renminbi with Beijing concerned about the prospects for the US dollar.

China is not the only country worried about exposure to the dollar.



Source: Morgan Stanley

In respect of countries that report the make-up of their foreign exchange reserves, the dollar as a % of those reserves has fallen from 71% in 1999 to 63% now. The dollar’s hegemony as a reserve currency appears slowly to be fading.

Social responsibility

With widening income disparities, Beijing is mindful of the risk of social unrest: China may be a one-party state, free of election campaigns, but its leaders must still produce results. Pockets of unrest have occurred, such as in Fengwei in SE Fujian Province on August 31 over industrial pollution.

The Party leadership appears to understand that among the most serious problems it faces are poverty in the countryside, the failure of the education and healthcare systems for hundreds of millions of the poor, and pollution. In addition to the huge expenditures on infrastructure, spending on social infrastructure is also being ramped up. In 2008 spending on healthcare rose by 37%, on education by 26%, on social security by 24% and the environment by 43%. The government has announced a massive three year Rmb850bn (\$125bn) healthcare reform plan that aims to provide a basic universal service. The establishment of reliable healthcare, education and retirement systems will, over the long term, allow households to reduce their precautionary savings and increase consumption. It will be a slow process – but this is one of the reasons we believe Asia as a strategic growth theme will remain robust for many years.

At a recent Sotheby's auction in Hong Kong, Chinese buyers sat low key and unassuming, mostly clustered in back rows. The paintings were sold for a combined HK\$182m compared with Sotheby's pre-sale top target of HK\$97m. "The Chinese are out in force. It's hard to outbid them." The Chinese also dominated the wine auction, paying a record US\$94,000 for one Imperial (six litres) of Château Pétrus 1982. Only 1% of the wine lots went to buyers who were not Asian.

Another string in Veritas' bow of 'real returns' is dividends, which are the "bird in the hand head-start in achieving real returns over time" (Charles Richardson, Chief Executive of Veritas UK and Manager of the Veritas Global Equity Income Fund). "Dividends are a critical element of long run gains in wealth."²

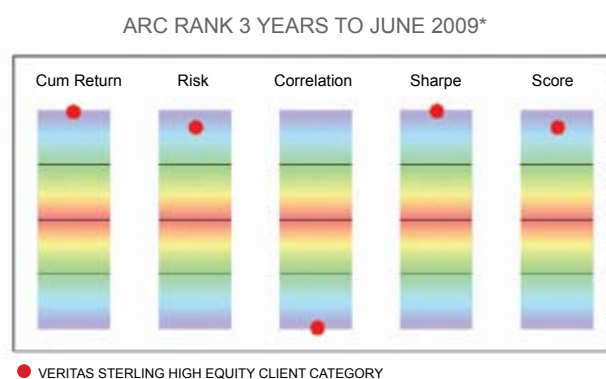
To illustrate the point, a share that we hold widely for clients is Vodafone. The quarterly valuation that we send clients of course reflects only the change in the capital value of the holding but not the dividends that have been thrown off. Shares bought three years ago would be up by just 3.5% on the original purchase price - but the dividends paid by Vodafone since then equate to 17% of the original

investment, taking the total return to 21%. This against the MSCI World Equity Index's total return of only 9% in sterling terms over the same period.

High yielding stocks with sustainable dividends tend furthermore to exhibit below-average volatility³, which is clearly desirable and another explicit Veritas investment objective.

Veritas Report Card

Certainly high yielding stocks have contributed to the results achieved for our clients, profiled by the independent firm of consultants, ARC:



Source: Asset Risk Consultants

We are pleased to report that, in the three years to 30th June 2009, our 'High Equity' category of clients ranked in the top decile of both actual and risk-adjusted returns (Sharpe Ratio) delivered by the 36 private client managers that ARC monitors. (Note that ARC rates low risk highly in the 'Risk' box.) In addition, our performance is amongst the least correlated with other managers, indicating that we provide effective diversification where portfolios are split between two or more managers.

Our performance is also significantly ahead of relevant indices over the period.

¹ Financial Times, 2 October 2009

² The Triumph of the Optimists, Dimson, Marsh & Staunton.

³ Do Dividends Matter More in Declining Markets, Fuller & Goldstein, 2005.



Meg Woods

12th October, 2009

* Unweighted averages of all clients with comparable investment mandates. "High Equity" accounts may be fully invested in equities.

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