

A VIEW FROM THE BRIDGE

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We would like to welcome readers to the first edition of A View From the Bridge.

Taylor Young is a private client investment management firm. As a research-led house, we enjoy our independence and our clients benefit from our ability to be flexible and agile operators in a complex world of investment management. We digest a vast amount of information from a wide variety of both City and non-City sources and have always sought to share our conclusions with our clients. In this and future editions of A View From the Bridge, we intend to take this process one step further and communicate our thoughts to a much wider audience. We want to stimulate debate and so feedback is very welcome. In the articles which follow, we consider the domestic economic outlook; reflect on the thoughts of one proponent of long-term investment seventy years on; and comment on two of our current themes for portfolio construction.

Over the last two years Taylor Young has been growing rapidly. Funds under management have more than doubled and six new managers have joined the fold during the last year. Peter Thomson joined in the second half of 2004 as our new Investment Director and Chief Investment Officer, after a period of eighteen years with Gerrard. The other managers who joined were Nick Rundle (the editor of this publication), Sir Christopher Royden, Robert Goodchild, Jason Toole and Christopher Buxton. Between them, these investment managers have amassed a total of 123 years of city experience (or an average of 20 years), which should further bolster the depth of knowledge and the strength of our business.

We hope you enjoy this first edition and please remember your comments, feedback or an opposing view are all very welcome.

*Audley Twiston-Davies
Chairman*

*Philip Todd
Managing Director*

A View From The Bridge

I was on my way back to the office from a meeting near the Bank of England recently when my taxi ground to a halt outside the Tower of London. Total gridlock for twenty minutes. Tower Bridge was being raised so all traffic in the area was brought to a shuddering halt. I was particularly annoyed as I realised that I had forgotten to check the very useful website – www.towerbridge.org.uk/BridgeLifts - that provides a weekly schedule of data for large vessels moving up and down the Thames. I had that morning studied company trading statements, investor research, currency movements and a number of portfolios but missed the *one key piece of information* that would have made my day rather less stressful.

Markets tend to work on this principle, too. Amidst the flurry of data, both local and international that is produced every month there is often one set of figures that is deemed to be of overriding short-term importance. These numbers are foreshadowed in the press and in research reports and are pored over and scrutinised in minute detail

afterwards. Share prices, currencies and bonds move in response and large scale inferences for the future are drawn, at least until the next month. What is interesting is how what is *seen* as the key data changes over time. When I first came into the City in the early 1980s the key figures in the market were the balance of payments data and reports from bellwether companies such as ICI. Today, the trade figures pass almost without comment and ICI, far from being the stalwart of the UK industrial base, is just another constituent of the FTSE-100 index, and not that far from the relegation zone.

As we look at 2005, what factor is going to be the key focus of investor attention and drive sentiment towards markets? My own suspicion is that it will be how sterling fares in the world currency markets. Throughout 2004, and particularly since the autumn, the big story in the currency markets has been the weakness of the US dollar. The press have had a field day with stories of European shoppers stripping Bloomingdales and Macy's and hapless American tourists paying \$8 for a coffee in Paris, and yet, for sterling, the trade-weighted value of the pound against

a basket of major currencies has moved relatively little. It has lost ground against the euro and gained against the dollar, but the currency markets appear to place the UK somewhere between an offshore European island and the 51st state. So far in 2005, somewhat perversely, the dollar has strengthened a little against other major currencies and given the substantial exposure to dollar-denominated profits in the UK indices, this has been a factor in the reasonable start that the market has made this year.

A bout of sterling weakness, though, could be the catalyst for the unravelling of the so-called Gordon Brown economic miracle. A situation of rising import costs, a yawning trade gap on manufactured goods and a government borrowing requirement which is moving steadily upwards from 3% of GDP is an unhelpful macroeconomic backdrop for any incoming government this year. Additionally, inflationary pressures within the economy are far from dormant and interest rates seem likely to rise by up to 50 basis points this year before reaching a cyclical peak, for the reasons outlined below.

The importance of how sterling performs is of vital importance for the health of the UK macroeconomic performance. The economy has been cushioned by a favourable move in the terms of trade by sterling's relative strength for a number of years now. Although commodity prices, and particularly oil prices have been rising steadily for the past year or so, the *sterling* price of these commodities has moved relatively little given the weakness of the dollar, in which currency global commodities are priced. Any major weakness in sterling would feed through relatively quickly to higher raw material prices, petrol price increases and, unless producers, retailers and distributors take a reduction in margins, to higher prices for goods and services to the end consumer.

Such a development would necessitate action on interest rates from the Bank of England. This has significant implications for an open economy such as the UK, more mercantile in nature than most of her European trading partners and also, on the domestic front, significantly more sensitive to domestic interest rate movements due to the high level of owner occupancy and, concomitantly, the level of mortgage debt.

2005 will, almost certainly, be an election year in the UK. Inevitably over the next few months there will be increased scrutiny in the media of the present Government's economic record over the past eight

years. Gordon Brown's key task, it appears, will be to focus attention on the past and avoid speculation on the future. Not only do the 'double deficit' issues need to be addressed, but the latest shock to the ostensibly rosy outlook is the truly horrifying picture outlined by the actuarial consultants, Watson Wyatt, of the state of the unfunded pension liabilities of the public sector. This is estimated at £690bn, over half as large again as the rest of the National debt of £410bn and compares with the market capitalisation of the London Stock market, at current exchange rates, *at the top of the market boom in 1999*, of £1500bn. **This is the legacy handed down to new entrants to the labour market – and pretty unappealing it looks too.**

No wonder there is speculation of large scale increases in both direct and indirect taxation. What is remarkable is how relatively muted the speculation has been in the light of the groaning and increasingly material strains the economy faces. However, despite the undoubted presentational skills of the current incumbent of the Treasury, world capital and currency markets act dispassionately and, as the events of September 1992 demonstrated, when sterling was unceremoniously removed from the ERM, can move with alarming speed. There is no particular parallel with 1992 today but I'm not sure how long the \$8 coffee in a Paris café will last.

So, if there is one key sign of a faltering in the UK economic performance, the currency markets may well be the first to pick it up. Unfortunately, unlike the Tower Bridge web-site, currency movements are rather less predictable.

Nick Rundle

Thoughts From A Long-Term Investor: JM Keynes In 2005

“It is the long-term investor...who will in practice come in for most criticism, for it is in the essence of his behaviour that he should be eccentric, unconventional and rash in the eyes of average opinion. If he is successful, that will only confirm the general belief in his rashness; and if in the short term he is unsuccessful, which is very likely, he will not receive much mercy. Worldly wisdom teaches that it is better for reputation to fail conventionally than to succeed unconventionally.”

J.M.Keynes; The General Theory of Employment, Interest and Money –pages 156-7.

Keynes wrote this somewhat cynical piece over seventy years ago, and in part it reflects his own experiences in the Stock market during the 1920s and the earlier part of the 1930s. Not only was he a dedicated investor for his own account, but he had also acquired a large degree of responsibility for the investments of his Cambridge college, King's, where he had been appointed First Bursar in 1924, and also for two Insurance companies, the National Mutual and the Provincial.

As both of his biographers, Roy Harrod and Robert Skidelsky note, his investment record over this period was not without blemish: he was surprised and shocked by the extent of the market falls between 1929 and 1932 but he did not lose his nerve. As the world economy gradually recovered during the mid to late 1930s, aided by rearmament and the adoption of policies similar to his own macroeconomic views, most particularly in the USA and Germany, his patient and reasoned approach to investment bore rich fruit. In the currency of today, his personal net worth on paper by the end of the 1930 would run to several million pounds.

Keynes was ahead of his time in that he was a keen analyst of the balance sheets of the companies in which he invested. At the time, a good deal of share price activity was generated by hearsay and also, then perfectly legally, the use of privileged or 'inside' information on individual company prospects. Keynes was a forerunner of the modern school of investment analysis, preferring as he said, 'the laws of arithmetic to the winds of rumour'. He also made the novel comparison between the success of an individual stock investment and a beauty parade, subtly believing that the most successful entrant in a 1930s 'Miss World' competition is not necessarily the most beautiful girl, but the girl the most people believe to be the most beautiful. Thus, he reasoned, the best performing stock in his portfolio might not be the highest quality stock in his judgment; it needed the approbation of a much wider audience and the deployment of hard cash as a voting mechanism.

Both of these perceptions are still as valid today as they were in the 1930s. The cash flow statement and balance sheet data of any company are naturally key tools for an equity investor to use in determining the merits of any investment decision. 'Fashion' or 'momentum' investing, much as in finding the winners of the beauty contest by reference to what other judges or investors currently think, or may come to think, is an acknowledged investment technique

currently utilised, amongst others, by some particularly aggressive hedge fund groups.

Keynes, would probably be unimpressed by the current investment focus on short-term performance, and also by the slavish attention paid by the modern consultancy profession to peer group benchmarks. Having chosen his stocks carefully, he stuck with them, unimpressed by short-term setbacks. Importantly, he never realized quick gains, preferring to wait patiently for long-term potential to develop. In this regard, his philosophy is similar to that of another great long-term investor, the Sage of Omaha, Warren Buffett. He also noted the importance of maintaining a diverse universe of investments, citing the example of holding gold mining shares in an equity portfolio, where the returns are unlikely to be correlated with industrial or financial equities.

From this last observation would come the formulation of what has come to be called 'Modern Portfolio Theory' – a way of combining certain types or classes of investments to diversify and lessen the overall risk of a whole portfolio.

Why, then, should the long-term investor come in for criticism? From all the factors noted above, the strategy and logic towards investment seems beyond reproach. However, the analysis does not take into account the emotional and human factors which can impinge on the investment process. The clue is in the last sentence of the quotation cited above; making investment decisions or forecasts contrary to so-called 'consensus' opinion can be, for an individual, rather uncomfortable. A degree of self-confidence is required to buy a stock that 'everyone' appears to be selling, or to sell a current market favourite that numerous commentators are praising to the skies. Yet experience shows that it is often these kinds of decision that in the long term prove the most rewarding.

One important observation in markets is often that a 'consensus' view, whether on a stock, a currency or an asset class often reflects a set of investment decisions that have already been taken. Additionally, views may also reflect partisan opinion – a successful estate agent is unlikely to maintain too downbeat a view on the residential property market, for example, but here over the past decade there has been a fortunate coincidence of self-interest and market direction. For equity investors, the experience of the last few years of those heavily exposed to technology issues, encouraged by over-zealous brokers, has been substantially less fortunate.

Long-term investors seek to screen out the random 'noise' in the marketplace and look to question 'herd' investment instincts. The problem is that the 'herd' may often be right – for a time. Inevitably, though, in a marketplace of individual human beings, irrationality and over exuberance are often followed by depression and gloom. In using the analogy of a beauty parade, Keynes undoubtedly recognised that analysis was only half the issue – emotional factors, most basically 'fear' and 'greed' impact sentiment and stock values too.

Recent data on ISA sales and data on the allocation of assets for the new Child Trust funds seems to indicate that the bear market of 2000-2003 has had a very damaging impact on sentiment towards equities in the retail sector. Insurance companies and corporate pension funds have been selling equities and buying fixed interest securities on historically low yields in order to reduce the perceived risks of their portfolios. 'Fear' has been the dominant factor in the markets of the new Century, at least until recently, in contrast to the 'greed' of the so-called 'dot-com' boom of the late 1990s. Yet the long-term rewards may yet fall to those, and Keynes would probably have been one of their number, who have taken an unfashionably long-term view of equity markets through the bear market of the early 21st Century.

The Themes for 2005....

One of the key beliefs at Taylor Young is that the markets respond to investment themes, both positively and negatively. If you imagine a lighthouse with a searchlight that sweeps across the investment landscape, certain parts of the landscape are brilliantly illuminated from time to time with the rest being in shadow. The key fact is that the beam moves and, therefore, some stocks that currently may be in the forefront of attention and interest can move back into the darkness and gloom when sentiment changes. Our job as investment managers is to try and predict what areas the lighthouse beam will illuminate next and, as a corollary, what sectors may fall into shadow.

One theme that has been in the forefront of our thinking over the past year or so has been the impact of the Chinese economic expansion on world markets. This theme led us to invest in mining and natural resource stocks, our reasoning being that China would boost its imports of raw materials such as iron ore, coal and copper in order to fuel its industrial growth. We have seen this reflected in the

upward movement in resources stocks such as BHP Billiton, Rio Tinto and in a number of smaller companies specifically orientated towards the Far East commodity markets. Whilst we still think that this theme has some way to run, it is possible that the majority of the gains may already have been made.

A new theme we are exploring in 2005 is that of 'de-equitisation.' Put simply, this means that given the relatively low level of nominal interest rates in the developed economies, it is often cheaper for companies to finance growth and investment plans through raising debt and borrowing rather than by issuing shares. Indeed, it is in many cases cheaper for companies to buy back their own shares and save the cost of paying dividends by raising additional debt finance. What this means is that some equity markets are, in effect, 'shrinking' and that the overall number of shares available for investors to buy is diminishing. This fact tends to act as a support to equity prices as both investors and companies themselves are acting as buyers in the market. Some companies, given their capital structure, are better placed to do this than others, and it is these companies we seek to find, arguing that these shares may perform better than those companies where there is no such buying demand.

Of course, the selection of shares to buy and sell depends upon a number of factors, but a focus on a thematic approach to investment should add an additional dimension to the investment process.

Please send your views and comments on any of the articles above to Nick Rundle at:

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