

A VIEW FROM THE BRIDGE

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As we enter the last few weeks of 2006, it looks as if we will record a fourth consecutive year of double digit returns from the UK equity market. Many other equity markets have also delivered double digit returns in the calendar year to date including the US, Germany and Hong Kong, although sterling strength has reduced the returns to UK investors. Away from equities, again for the calendar year to date, returns from UK commercial property have been extremely strong but UK gilts have underperformed cash.

We, at Taylor Young, want to be known for the thematic thinking that goes into our overall investment strategy. In terms of how we allocate assets and construct portfolios, the first two articles explain in some detail the thinking behind two of our major themes - outsourcing and the introduction of REITs (Real Estate Investment Trusts). These two articles are based on the text of addresses given at our Investment Conference, as is the third article, which is an abridged version of the address given by Andrew Hunt, a leading City economist, whose research we subscribe to.

Our fourth article is perhaps a departure from tradition (this is the eighth edition of this quarterly publication) and we set out to share, with a wider audience, some of the recent developments at Taylor Young including the launch of our revamped website, www.tayloryoung.com.

Philip Todd
Director, Private Client and Charities

Peter Thomson
Chief Executive Officer

Investment In Real Estate Companies

This is the text of an address given by Nick Rundle at the Taylor Young Investment Conference on November 8th 2006.

As you know, at Taylor Young we are thematic investors - we believe that by identifying investment themes and investing in companies relevant to those themes we should be able, over the medium term, to outperform market indices. This morning, I would like to talk about one of the themes that we have been particularly enthusiastic about over the past two years, that of investment in real estate companies in the UK. Why have we been so bullish of this area? There are a number of reasons.

Firstly, institutional diversification. Large investment funds, including pension funds, have been under some pressure from their actuaries and fund advisers to diversify their asset base which was previously heavily biased towards equities. In the 1970's and 1980's, funds typically held well over 10% of their assets in direct property but over time and given the long bull equity market that developed from the mid 70's until 1999, the percentage of their portfolios invested in property had tended to diminish. Similarly, the size of the quoted sector within the market fell too and, given the rise of benchmarking against industrial sectors, overall exposure towards property fell considerably over this period. However, property has a number of defensive characteristics and its returns over time tend to be somewhat uncorrelated towards the returns from equities and fixed interest.

To this end, institutions have been rebuilding their weighting in direct property and also where possible in the quoted property sector. In many ways, it is easier to invest in the quoted sector as it is more liquid and cost effective than investment directly. For instance, individual buildings can be costly to buy and sell given agents fees, Stamp Duty and liquidity issues, and also tends to require maintenance. A share in, for example, Land Securities, can be bought and sold on a daily basis. There are however some tax considerations which I will come on to later.

Secondly, a major consideration is the persistence of the relatively low level of interest rates worldwide over the past 10 years. This has allowed investors to leverage up their portfolios considerably. Against a background of generally rising capital values, together with an income stream often higher than the cost of borrowing, leverage has made a lot of sense to those prepared to borrow. To some extent, this has been mirrored in the residential market by the explosive growth of "buy to let" over the past 10 years.

Thirdly, there has been a dramatic inflow of money into the UK property market from overseas. For various reasons, investors in Russia, China and the EU have seen the UK as a solid and reliable base in which to invest. Planning restrictions have tended to keep capital values high, and the development of London as a premier centre of world capital markets has encouraged significant new inward investment particularly into London and the South East.

Lastly, this is of particular importance over the last

year, the tax basis of the quoted sector is set to change. This change comes from the introduction of REITs (Real Estate Investment Trusts) introduced in the Budget in the spring. Nothing is as yet set in stone for this legislation and indeed a number of changes are still being made, following consultation between the industry and the Treasury, but the key outline is that for a one-off conversion charge of around 2% of assets, property companies will be able to relieve themselves of the restrictions of capital gains tax on their assets, providing that they distribute a high level of their earnings to their investors.

This has a major impact on a number of the well-established companies, who have built up capital gains tax liabilities over the past 30 or 40 years. It is notable that under the current regime the majority of our domestically quoted property companies trade at a discount to net asset value whereas where REITs have been introduced, the companies tend to trade at a significant premium. We envisage that a similar pattern of investor activity will occur once REITs are introduced and the companies convert in 2007. Also, there is a global pool of investor capital which is orientated towards the global REIT market and which currently is unable to invest in our property companies as currently constituted. This pool of capital will be open for investment in the sector once the companies convert.

As an example of the position that we have taken in the real estate sector, the Equity Income Fund currently holds over 10% of its assets in real estate against a benchmark weighting in the All-Share Index of around about 2%. This is represented by three key companies, Land Securities, Hammerson and British Land. All three have indicated that they will move to REIT status when legislation permits in 2007 and this will, in our view, unlock further value within these companies, particularly the value of their outsourcing interests, and in the case of Hammerson a development portfolio particularly strong in Western Europe.

As an indication of the strength of the current commercial property market, it might be useful to give one or two examples. In the West End of London, 5 yearly rent reviews for space last assessed in 2001 at around £40 a square foot are coming in at between £75 and £80 a square foot for relatively prime sites. A number of trophy buildings in the City of London have been placed on the market by Middle East investors recently and already it appears that at least a couple of these have found firm interest within 2 or 3 weeks of being placed on the market. An example of the enthusiasm towards slightly less central out of London property came recently with the sale by Hammerson of a supermarket site with car

park in Romford for the sum of £380m to a group of Irish investors. This demonstrates that two of the key factors in driving the commercial market are the low level of interest rates within the EU and the keenness of overseas investors to gain exposure towards property in the London area.

The question of course we have to ask is will this boom continue? Were interest rates to rise significantly from current levels, this would tend to put a dampener on commercial activity as would a rise in Stamp Duty from the current 4% level. However, it is our view that institutions will continue to diversify their portfolios into assets away from equities and that property and property companies are seen in many ways as a better match for their liabilities over the long term, given that property provides a sound stream of income coupled with some protection against inflation. London's role as a financial centre is again of key importance and another key driver of this has been the number of overseas companies, particularly from Russia, which have listed on the London Stock Exchange in preference to New York, given the current onerous corporate regulatory regime that exists in the United States. It has been observed that any large aspirant Russian company, particularly those that enter the FTSE directly, needs a substantial London base and again this has contributed to significant uplift in demand for prime space within London and the West End. In our view, this is also an attractive area for private client investment given its transparency and asset backing.

Overall, therefore, we are happy to continue to maintain our position in the quoted real estate sector and await the arrival of REITs in 2007 with great interest.

Outsourcing

This is the text of an address given by James Oldham at the Taylor Young Investment Conference on November 8th 2006.

A theme that Taylor Young has consistently played in one form or other over recent years has been that of outsourcing. We all have personal experience of outsourcing, some of course with mixed results, such as in our day-to-day dealings with some UK high street banks, the UK directory enquiry service or dealing with a life assurer. However, outsourcing as a strategic business tool has been around for decades and, overall, the arguments for outsourcing to companies, governments and ultimately consumers are compelling. The main functions outsourced include IT, training, supply chain and logistics, HR, finance and accounting and consumer relationship management.

Why outsource? The key three reasons are as follows:

- To reduce costs;
- To improve processes and efficiency;
- The increased ability to focus on the core business.

Taylor Young is a good example. We are largely made up of people that have worked for much larger organisations and a move to a smaller organisation allows the investment professionals to focus solely on what we set out to do. Our primary banking and custodial relationship is outsourced to Adam & Co, part of the Royal Bank of Scotland, and our IT and telecoms contracts are also dealt with externally, as are the cleaning, catering and building maintenance functions. Of course these functions all vary in importance to the success of Taylor Young, but the key functions which are outsourced are not simply contracts with detailed service agreements, they are actually long-term business relationships. This leads us to be leaner as an organisation, allows us to benefit from economies of scale and frees up management time to focus on the core business of managing our clients' assets.

Turning to quoted investments, there are many examples in the UK of companies which continue to benefit from the outsourcing theme. Over the years, we have invested in numerous such companies, such as T Clarke, VT Group, MITIE, White Young Green, RPS, WSP, Speedy Hire and Capita.

A classic example of long-term, innovative success in this space is Capita. Capita is a company that many readers will have come into contact with, whether knowingly or not is another issue. Indeed, the growth in the outsourcing industry is reflected in the company's own growth record. The business floated on the UK market in 1989 with a market capitalisation of £8.1 million and now forms part of the FTSE 100 with a market capitalisation of over £3.2 billion.

Why has Capita been so successful? Well, it has been at the forefront of the evolution of business process outsourcing, helping the private sector to stay ahead of the competition and assisting the public sector organisations in meeting the needs of their communities. Its innovation and desire to push the boundaries of what is possible through the use of streamlining and technology has led to some extraordinary results and market positioning. If one considers that there are about 60 million people in the UK, it makes the following examples of Capita's scale all the more impressive:

In terms of Document Management, they:

- scan in excess of 110 million images per annum
- print 70 million items per annum

In terms of Life & Pensions, they:

- administer over 3.4 million life, savings and

pensions policies

In terms of Financial Services, they:

- administer shareholder communications to seven million shareholders
- manage over twelve million share transfers in 2005
- manage movements in client funds in excess of £34bn in 2005

In terms of Insurance Outsourcing, they are involved in:

- approximately 3 million household and travel policies issued in the UK each year
- handling over 2 million legal and medical calls on behalf of clients each year

In terms of Occupational Health Services, they:

- are the largest privately owned occupational Health provider in the UK
- provide services to 900 corporate clients, covering over 2 million UK employees

In terms of Contact Centres they:

- employ 5,000 staff and handle 25 million customer contacts per year

In terms of IT Services, they:

- provide IT support to over 2,400 schools in the UK

In terms of Local Government Software, their:

- council tax software issues over five million bills and collects over £4bn in council tax each year

Congestion charging:

- Capita collected over 25 million payments in 2005
- 1 million images of vehicle movements in the zone are captured daily

TV Licensing:

- Capita collected £2.9bn in licence fees in 2004/05

I should also add that Taylor Young is a client of Capita as it is they that act as administrator and Authorised Corporate Director to our Growth, Growth & Income and Equity Income funds. Why did we outsource? The reason is that we simply cannot match the economies of scale that Capita achieve and, of course, the administrative side to managing Funds is a non-core activity that we are more than pleased to outsource.

So, outsourcing affects us all and is a theme and trend that is set to continue. As investment managers, we are spoilt for choice in the UK, as there are a number of 'class acts' to choose from but, one word of warning, the shares are often expensive and therefore the entry and exit point is crucial.

Global Review: The Never-Never Boom

This is an abridged text of an address given by Andrew Hunt at the Taylor Young Investment Conference on November 8th 2006.

Since the mid 1990s, central banks have targeted official inflation rates with their monetary policies; however, since the emergence of the Asian crisis in the late 1990s and the subsequent emergence of China as an economic superpower, these targets have proved easy to attain. The consequence of this is that interest rates have been maintained at too low a level for the past five years or so.

This low level of interest rates has encouraged a boom in personal borrowing, particularly in the UK, where at the same time the industrial base has been shrinking and employment in the public sector and service sectors has been increasing. The result has been a widening current account deficit which has not yet affected the international value of the pound, as central banks have remained buyers of sterling, attracted by interest rates higher than those available in Europe.

Europe's interest rate regime is constrained by the euro; some parts such as France and Scandinavia are prospering, whilst Germany's economic recovery is somewhat hesitant and Italy's fiscal position remains a significant problem.

Economic growth in Japan appears to have stalled a little recently, whilst investment levels in the Pacific Rim economies stagnate, as local entrepreneurs seek growth opportunities outside their own economies. However, prices of Asian exports have been artificially depressed by China's recent structural problems and this factor has been key in keeping OECD inflation rates low over the past five years. There are signs that the unbalanced nature of China's economy will compel export prices from the East to rise during 2007, placing upward pressure on inflation rates in the developed world.

So far, muted inflation rates have allowed the boom in credit availability and demand to remain intact in the USA and UK, and global growth may surprise on the upside for the next two or three quarters, but thereafter the headwinds of higher export prices from China and Asia pose inflationary problems for the Western World.

Recent Developments at Taylor Young

The last three years have been very exciting for those of us who work at Taylor Young. There have been many changes which we like to think of as evolutionary rather than revolutionary. Much of the change has stemmed from a significant injection of human capital throughout 2004 with the arrival of six Investment Managers. In that year, Peter Thomson was appointed as Chief Investment Officer and in

May of this year Peter additionally took on the role of Chief Executive Officer. Over the last three years, we have seen a rapid increase in funds under management, which went through £500m earlier this month. Our investment offering now includes both traditional and alternative asset classes and should appeal to a wider range of types of investor - people looking for wealth preservation or income generation, as well as the more traditional requirement for wealth creation.

The 6 April 2006 (A Day) saw major changes to the pension regime for all types of pension. Now that the changes to the legislation are more widely understood, we are seeing considerable interest in SIPP's (Self Invested Personal Pensions) and SSAS's (Small Self-Administered Schemes) and these have been an important source of new business. We have established strong relationships with a small number of pension advisers and pension providers and our genuine recognition of the life-cycle nature of a pension investment strategy is perhaps what most appeals to our clients. This very basic recognition that client investment objectives change over time plays to our focus on client meetings and regular mandate reviews for all types of client. Recent client meetings have triggered interest in our AIM IHT service - a portfolio invested in AIM companies with the specific objective of potentially making considerable inheritance tax savings.

A more recent development has been the revamping of our website www.tayloryoung.com. Further enhancements are planned but the website is a fairly comprehensive portrayal of where Taylor Young is today. So please have a look and let us have any feedback - positive or negative (if you do not recognise any of the bridges, hover over the image and the name will appear with the exception of Tower Bridge!).

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

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