

Investment Review – 15 August 2007

There is little point in repeating the acres of newsprint on the current state of the market; the origins of this setback lie in the sub prime loans market in America. These loans were made to people with no obvious means of repaying them at artificially low rates of interest and when the true rate kicked in, the value of the houses had declined. Forced selling has only increased the problem. In days gone by, this would be a regional, American, problem.

However, the ability of financial engineers to carve up these loans in to separate parcels, and to dress junk up as triple A, means that no one knows who owns these loans, and if they go bad, who will be affected.

To compound the problem, hedge funds have, in some cases, used extreme gearing to try to obtain enhanced returns. In a world awash with cheap money, yields on bonds had been driven to unsustainably low levels, to the point where there was no longer any reward for risk. The unwinding of these positions is clearly painful, if indeed they can be unwound. As the bond markets have dried up, the next realisable asset class has been equities, hence the steep falls.

It is also worth remembering that there are operators who will have benefited hugely from shorting these markets. One of our associates holds a hedge fund that has been shorting sub prime, and has returned more than 300% this year.

It is impossible to say where this will end, but we continue to think this is a financial market problem that will have very little effect on the real world. Tesco, for instance, has fallen 13% from its peak, but are the prospects for that business significantly worse than they were two months ago?

The wall of speculative cash has now gone, and that has to be a good thing. It is also unlikely that we will see further rate rises in all but Japan. Markets will be volatile for some time to come, but global economic growth remains robust, and eventually fundamentals will reassert themselves.

Perhaps the only surprise is that this has taken so long to come home to roost; gearing up to buy low quality assets is seldom a good plan, as many sub prime loan holders have discovered. Dressing these loans up to look respectable is a scandal, but no doubt people are hard at work creating the next variation. Such is the nature of markets.

In summary, we believe that the economic outlook in the real world remains both positive, and robust, and that will come to the fore.

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15 August 2007