



INVESTMENT UPDATE

17 September 2008

The demise of Lehman Brothers (the fourth largest investment bank in the US) the takeover of Merrill Lynch and the capital concerns at AIG (the world's largest insurance company) has sent shockwaves through global equity and bond markets. Understandably, shorter-term investors have taken fright and are selling down their equity and corporate bond positions in favour of government bonds and gold. AIG has now been bailed out by the US Federal Reserve with a loan of \$85 billion to avert further turmoil in global credit markets.

Speculation about the state of Lehman Brothers' financial position has continued since the rescue of Bear Stearns in the spring. Having already fallen 80%, the bank's share price fell heavily last week, reducing the value of Lehman's to a small fraction of its previous worth. The problem stemmed from its holdings of US mortgage-related assets on its balance sheet, exacerbated by the bank increasing its exposure in response to the credit crunch.

These assets represented a substantial portion of the bank's asset base, which in turn provided the solvency it needed for its trading and lending activities. The market for these mortgage assets is severely impaired and Lehman's had no choice but to write-down their value on its balance sheet. This affected the bank's ability to raise capital and ultimately to satisfy minimum solvency requirements. The reason the mortgage-backed assets fell in value was ultimately default risk, but also considerable uncertainty created by the manner in which they had been packaged.

Takeover rumours were rife but in the end Barclays pulled out, as they were not prepared to take on parts of the bank without US government, or other Wall Street firms, to protect against losses. Bank of America decided to bid for Merrill Lynch at a late stage having withdrawn from talks with Lehman. In the meantime, it became apparent that Lehman's toxic assets were around \$88 billion not \$33 billion as the

market had thought. The Federal Reserve then decided to let the market take its course, with the holding company for Lehman Brothers declaring Chapter 11 bankruptcy. Certain Lehman subsidiaries such as the valuable asset management and broker-dealer parts of the business have not declared bankruptcy and there are hopes they may yet survive, to be sold on an on-going concern basis. Indeed Barclays has announced this morning that it is to buy Lehman's North American investment banking and capital markets business at the "knock down" price of £140 million.

The figures for this bankruptcy are incredible. Lehman Brothers has debts of around \$613 billion and assets of \$639 billion - so dwarfing WorldCom's insolvency six years ago. Shareholders are likely to see no return, whilst bondholders holding senior debt may see a return on their dollar. Bond managers in the UK are estimating that this may be around 30 cents in the dollar.

Effect on the Market

So what are the wider effects of this further turmoil in the financial markets? Liquidity is a problem so central banks around the world have injected billions into the money markets to try and stabilise them. The Bank of England injected £5 billion on Monday and announced the injection of a further £20 billion in short term funding yesterday. The world's ten largest banks have also created a "liquidity pool" of around \$70 billion to provide emergency funding. Any of the ten banks may draw upon up to 30% of this pool should they require it. Interest rate cuts are also expected, in an effort to stimulate economies around the world - especially as there are now signs of inflationary pressures easing.

Presently, considerable uncertainty prevails - AIG (the World's largest insurance company) announced a \$40 billion capital requirement on Monday and has now had to be supported by the Federal Reserve. Part of AIG's problems stem from insuring credit risk in relation to financial instruments connected to US sub-prime mortgages.

HBOS - which is the holding company for Halifax and Bank of Scotland is estimated to have need of refinancing around £100 billion of mortgage debt. The lack of liquidity in the wholesale money markets has led to doubts about this refinancing and consequently the share price of HBOS has plunged, even though there is little reason to doubt the quality of its underlying loan book. Even the survival of those institutions with lower risk business models, (HBOS has a huge depositor base), is being tested by the financial markets. As we go to press, there has been a recovery in HBOS' share price with rumours that Lloyds TSB is to buy it.

Year to Date Market Returns

Index	% Return YTD
FTSE 100 TR	-19.10
FTSE A British Govt All Stocks TR	2.35
FTSE All Share TR	-19.13
FTSE Asia Pacific ex Japan TR GBP	-24.73
FTSE Europe ex UK TR GBP	-19.05
Hang Seng TR	-23.63
Nikkei 225 CR	-11.43
S&P 500 TR	-5.02

Source Lipper Hindsight 02/01/08 to 16/09/08,
Total Returns expressed in UK£.

Our Immediate View

As we have explained, events have been moving very rapidly – though in many respects predictably. We expected a period of considerable volatility – though it now seems likely to continue well into the autumn, which is for longer than we expected. We originally said we expected a continuation until August 2008 at least, based on 12 months' reporting from the banks, following the emergence of the 'credit crunch' last summer.

Certainly, four quarters of reporting have brought huge write-downs from many of the world's leading banks – with the weakest players exposed, together with some banking failures too. It may be that the worst is over – although analysis suggests that only 50% to 75% of US sub-prime write-downs have yet taken place. Even on the most optimistic view therefore, we have to expect substantial further write-downs and the consequences that will flow from them. It seems likely that there will be further casualties in the financial sector, but also that the central banks will allow insolvencies to occur, provided a 'domino effect' can be avoided. It seems prudent to protect taxpayers from the financial consequences of nationalising 'toxic' assets and to force private investors in the banking sector (which often include management and staff in the banks concerned) to bear the losses. Had Lehmans been rescued, Federal money would almost certainly have been used virtually immediately to pay large bonuses that were owed to management and staff. This would have seemed totally unacceptable to the public (and electorate!), given Lehmans failure to manage its affairs properly.

Against this very volatile background, we advise clients who are invested in equity and bond markets with longer-term objectives of capital growth and/or income production to remain so. The credit crunch needs to play out and liquidity to return before markets can rally on a sustained basis. There are a number of reasons to be positive longer term, not least the reduction in the oil price and the prospects for downward movements in inflation and interest rates. It seems likely that deep recession will be averted too – and most listed companies continue to trade and to make profits. In

many sectors earnings prospects remain quite favourable and yields are high. For those already committed to equities, it makes sense to await an upturn – even if the market falls further short term in exceptionally volatile conditions. Selling when prices are depressed makes no sense – unless one can be certain of re-purchasing as they begin to rise. Accurate market timing is notoriously difficult.

For those clients and prospective clients contemplating new investments, our investment management process always takes into account your objectives and attitude to risk. We devise tailored portfolios reflecting your requirements from the very cautious, through balanced to adventurous. Your risk attitude may change over time, which we can then reflect in your portfolio.

Cash management is an important element of portfolio management at this time. We recommend cash funds, national savings and cash deposits to try and ensure a broad base of deposit takers, so spreading risk whilst offering attractive returns. With the use of regular reviews in our investment service, we can advise when clients should move from cash to other asset classes to maximise returns.

All clients should remain aware of the need to avoid depositing more than £35000 with banks that may be deemed vulnerable to failure. An easy way of diversifying cash holdings (and of taking advantage of the liquidity shortage in the wholesale money markets) is to invest in cash. We usually recommend funds that invest in safe short-term cash and near cash instruments. As is evidenced by the LIBOR/base rate differential, funds that lend cash short term via the money markets can provide a significantly superior return to bank/building society deposit rates, whilst spreading risk considerably.

If you have any concern with regard to the level of risk within your portfolio please contact your Cartlidge Morland consultant.

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