

MONTHLY INVESTMENT COMMENTARY



AUGUST 2011

INTRODUCTION

When we issued an additional bulletin on 27 July 2011, it was against the background of reversals in equity markets and considerable investor disquiet – mainly caused by the unresolved problems of the euro zone and Standard & Poors' downgrade of US Treasury debt to below an AAA rating.

Our view then was that markets were offering fair value, but warned that further short-term falls could not be ruled out. Since 27 July, markets have sold off. We have set out the Sterling-adjusted movements in the relevant indices below:

FTSE 100 (large-cap UK Equity)	- 12.46%
FTSE All Share (all listed UK shares)	- 12.74%
FTSE Europe ex UK (European shares, UK excluded)	- 19.45%
S & P 500 (leading 500 US shares)	- 17.19%
IMA Corporate Bond (an index of corporate bond funds)	0.87%
IMA UK Gilt (an index of gilt funds)	4.37%

Source Lipper 27/07/11 – 23/08/11 %Total Return UK£

INVESTOR LOSSES

The virtue of a balanced portfolio is that, to a significant degree, it should insulate the investor from extreme losses. When a major sell-off occurs in global equity markets, then traditionally money flows into the relative safety of the bond markets. UK gilts, German bunds and US Treasuries are considered safe havens and money has flowed into them, even though the yield offered is relatively poor. For this reason, UK gilts prices have risen markedly in recent weeks, further depressing the modest yield offered, which is now well below the current UK inflation rate. Most Cartlidge Morland clients have significant corporate bond exposure in their portfolios, which has protected them from loss whilst continuing to offer a good return. We also hold gilt funds (conventional and index linked), although we have preferred corporate bonds for their higher income yield. Our position in commercial property – biased towards 'bricks and mortar' rather than property company shares - has also offered protection from losses.

Our 'balanced' portfolios typically have 25% to 35% exposure to UK equities. Knowing that economic conditions remained uncertain, but wishing to reap the rewards of an improving UK equity market, we maintained a heavy weighting to 'equity income' funds. The latter funds are more defensive, because they concentrate their investment in shares offering above average dividend yields – or in companies that seem likely to increase their dividends. The total dividends paid by UK companies are expected to rise 27% this year which should support share prices, whilst providing investors with a good income. Against this background many UK stocks now appear cheap, as they were offering decent value at July's prices.

For your information, we have set out below the movement in the prices (since 27 July 2011) of four of the equity income funds most commonly held in Cartlidge Morland portfolios.

Invesco Perpetual High Income	- 6.25%
Newton Higher Income	- 8.77%
Rensburg UK Equity Income	- 9.05%
Threadneedle UK Equity Income	- 10.39%

Source Lipper 27/07/11 – 23/08/11 %Total Return UK£

Given that UK shares have lost 12.74% over the period, these equity income funds have demonstrated a degree of resilience, as we intended. It is also interesting that until relatively recently the Newton Higher Income and Invesco Perpetual High Income funds had lagged the market recovery quite considerably. Neil Woodford, the 'star' manager of the Invesco Perpetual fund, has taken a relatively bearish view post credit crunch and had positioned his fund accordingly. This said, even before the latest falls, Neil Woodford had also identified almost indecent value in certain UK stocks, and that was well in advance of recent falls.

European markets, and especially the German market, tend to sell off rapidly if sentiment changes. Panic broke out on European bourses driving share prices across Europe down by 19.45% since 27 July. We have generally been slightly overweight US versus Europe and we had been taking and consolidating gains from our direct German holding (Baring German Growth) in particular. After exceptional gains over several years, the price of that holding is back at December 2009 levels.

Asia Pacific markets have held up relatively well during the recent turmoil, having fallen further back earlier in the year for other (connected) reasons. The fall in the US market is a response to fears over future growth rates, although ironically, the news flow from the US is (on balance) encouraging.

STRATEGY

There is no point in making losses permanent by selling now into weak markets. To reduce participation removes the prospect of recouping losses through recovery. Of course, we cannot guarantee there will not be further losses whilst investors remain so nervous and economic/political events unpredictable. We can only look at 'value' and take a view as to whether assets are fundamentally under-valued, fully valued or expensive. Efficient markets will eventually price with reasonable accuracy and presently, equities are under-valued and UK, German and US sovereign debt is over-priced, as is gold. The present emphasis on capital preservation and safety is keeping the price of those assets high.

Some 'balanced risk' investors may at this stage wish to take a more bullish view, cautiously reducing the proportion of their portfolios held in highly priced lower risk assets, in order to increase equity exposure whilst prices are lower. Those with heavy cash weightings should consider investing in 'real' assets now, with equity income funds yielding around 6% p.a. Ultimately, equities are likely to offer a 'real' return in an environment when inflation is elevated but cash deposits will lose value in real terms, as will gilts unless prices are driven even higher, which seems unlikely.

Other investors will already have sufficient exposure to equities, or as much as their capacity for risk may allow. These investors should not increase their equity weightings, as they will in any event benefit when prices improve.

European, US, Asia Pacific and Emerging Markets equities are all at much lower levels and we shall be seeking to take advantage of lower prices in our asset allocation decisions.

The continuing global economic recovery is proving slow and protracted, which we expected. Markets have been desirous of a more rapid recovery and certainly, the consequences of missing fairly lacklustre growth targets are potentially significant

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for heavily indebted economies. All this said, the corporate earnings reported during very difficult conditions have been more than satisfactory and the yields from shares are relatively high. Whilst global recession or economic stagnation would create a headwind, it would not prevent efficient companies from making decent profits, although there would be less growth. We are bullish given present equity prices and UK bond prices will continue to be supported by low interest rates, even though inflation is higher than the bond markets would normally feel comfortable with.

The banking sector remains a serious concern; partly due to the exposure of international banks to problem European sovereign debt, but also due to the shortage of capital caused by write-downs on US mortgage securities. Banking shares have been seriously hit by a perceived need for many banks to raise more capital, which is also partly a result of higher international standards being imposed. If the banks suffer a shortage of capital, they reduce their lending, in turn hitting both businesses and consumer consumption.

MARKET TIMING

Our 'timing' or 'emphasis' is based on our perceptions of (a) value and (b) momentum. On a medium term view one can reasonably anticipate that 'value' will eventually be reflected in price. Sometimes one may take a view that a particular sector or theme will be of lasting popularity with investors and that one should gain exposure to that momentum, which will drive the price of an asset upwards. In recent years, Asia Pacific and Emerging Markets are good examples – although importantly, longer-term value has also been in prospect.

Our conviction depends more often on perceived value than momentum. The dangers in momentum investing are that sentiment can change rapidly, resulting in dramatic loss. The other danger is that one becomes convinced of the momentum argument in a particular area too late – only to forfeit better opportunities elsewhere, in order to participate in a lacklustre final phase.

Analysis and testing has frequently proven that those who claim to get market timing 'right' are 'wrong' more often than not. For this reason, professional managers will tend to maintain diverse portfolios, with changes of emphasis - rather than wholesale moves into cash or from one sector to another. The downside risk of the wrong call being made is otherwise too high – and the volatility typically associated with 'high conviction' management, too much for the majority of clients.

The Association of Private Client Investment Managers (APCIMS) publishes indices indicating very clearly that even those managers with 'discretion' (those that can buy and sell without the permission their clients) make relatively slight changes in emphasis gradually, rather than dramatic decisions for or against particular investment sectors.

In general, Cartledge Morland 'balanced' portfolios tend to have less overall exposure to equities than the average APCIMS balanced portfolio. We typically carry a similar level of exposure to fixed interest, although mainly in corporate bonds. APCIMS is a model and carries an inbuilt assumption that all fixed interest exposure is in gilts. The APCIMS portfolios carry a weighting to UK equities that is normally at least 10% higher than in the typical Cartledge Morland portfolio. Our equity exposure tends to be more international, on the basis the UK market accounts for less than 11% of global capitalisation and we prefer to extend opportunity via broader international holdings.

Early indications are that our portfolios have weathered the recent storm in good order, with overall losses contained at levels well below that suggested by the market indices and indeed the APCIMS Balanced Index.

GOLD

Global currencies have not been tied to gold for many decades – the role of gold in the financial system is solely as a 'store of value'. Gold does not provide an income nor any other form of yield, it has no prospect of doing so and there is also potentially the cost of storage. It cannot therefore properly be described as an investment. However, it is a substance of desirable appearance that is reasonably portable and in limited supply. It is inter-changeable for goods and services and is often held as part of a nation's strategic financial reserves which may in turn offer some form of credibility to a currency.

Traditionally, when investors lack confidence in financial markets, paper currency or institutions, they turn to gold. The dollar (the world's reserve currency) has fallen in value, so for large overseas holders such as the Chinese or the oil kingdoms, it has not proved a good hold in recent years. The euro zone now has considerable problems and as we are seeing with the Swiss franc, potential havens such as the Swiss Franc and Sterling can only absorb limited global capital flows. Furthermore, the return for holding such assets in banks is very limited given current interest rates, whilst the banks themselves may prove to be at risk. Unlike most private investors, substantial international investors are largely unprotected by state protection schemes for depositors. Against this background gold is likely to remain in demand, although global production is likely to increase in response.

For a return from gold, one is relying on future buyers to continue driving the price up. The market has acquired a momentum of its own, which to a significant degree is irrational, especially for the smaller investor who is denying himself an income, in order to speculate in commodities. In the 17th century tulip bulbs held a similar fascination: there was a limited supply, everybody liked the flowers, the price per ton rose relentlessly and it seemed ridiculous not to participate by investing part of one's capital in them. Eventually, investors realised the limitations of tulip bulbs and the herd mentality later resulted in enormous losses.

Gold will always have greater intrinsic value than tulip bulbs, not least due to its superior durability and its role in the international financial system. This does not mean there will not eventually be significant retail investor losses - it is only a matter of time before the 'big' money moves elsewhere.

We have not allocated our clients' money directly to gold, although given the exceptional returns from gold in recent years and the current publicity given to the price of gold, we felt we should explain why. For those of our clients who nevertheless wish to hold gold as an investment, we can make the necessary arrangements when required.

TRACKING FUNDS/EXCHANGE TRADED FUNDS

Index-tracking – which is all these funds do – reduces costs for investors and can offer broad or targeted exposure to certain markets. The more targeted the exposure, the greater the professional input likely to be required to determine asset allocation decisions.

We continue to hold some tracking exposure in many of our portfolios, but it has reduced in recent years. The composition of the FTSE 100 and FTSE All Share Indices has altered to the extent that risk is elevated by over-exposure to particular sectors or stocks that are weighted heavily in the index. By their very nature, indices of any nature carry random weightings and in highly volatile conditions, we consider a researched stock-picking approach is likely to provide superior return, whilst involving less risk.

This does not mean that in different market conditions we shall not wish to increase the level of index-tracking/exchange traded fund exposure within our portfolios.

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