stocktake

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The quarterly investment review for Selftrade clients

Issue 3, August 2006

This third edition of Stocktake (and the first under our new Selftrade brand) focuses on markets and the global economy.

Geo-political tensions and inconclusive economic data have had a mixed impact on the market with a slow down in earnings growth long predicted. The UK market has found support at 5,500 and while it has remained spirited, has failed to re-gain the considerable ground it lost during May. This correction seems to have been caused by a surprise inflation increase and consequent interest rate rise in the US and Europe.

We have a broad array of contributions in this issue. Emma Brandwood of Legal and General gives her views on world stock markets, Schroder's Andy Brough assesses the performance and potential of mid caps, Paul Brain of Newton considers the recent growth in the fixed income market and asks if it will continue. Elsewhere, Martin Weiss, Product Director at Invesco Perpetual focuses on Latin America while regular Mark Glowrey surpasses himself with two articles, one technical index analysis piece and another discussing the merits of holding bonds within the tax efficient environment of an ISA.

As usual, we would like to hear from you. Please email comments or suggestions (for publication or otherwise) to **marketing@selftrade.co.uk.**

Fund News

Gartmore Focus and Multi Manager ranges of funds - no initial charge until October 1st

Improved discounts on Jupiter funds

Schroder Mid250 Fund - no initial charge until October 1st

M&G Recovery Fund - no initial charge until October 1st

Minimum investment on the majority of funds now at £500

JP Morgan - range of funds tripled

Coming soon - Funds from:

Resolution Asset Management

Scottish Widows Investment Partnership

This is not a recommendation or an offer or solicitation to buy or sell the funds listed and is provided for information purposes only.

Top 10 Providers

Invesco Perpetual
Jupiter
Fidelity
Artemis
M&G
Merrill Lynch
Legal&General
Gartmore
AXA-Framlington
JPMorgan

Top 10 Funds

Merrill Lynch Gold and General
Jupiter European Opps
Fidelity Special Situations
Invesco Perpetual High Income
M&G Index Tracker
L&G UK Index
Artemis UK Special Situations
Artemis European Growth
Gartmore China Opps
Invesco Perpetual Latin America

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Market Overview and Outlook

Emma Brandwood gives Legal and General Investment Management's views on world stock markets.

Over the first 6 months of 2006, major world share markets gave investors mixed returns following the sharp global market correction in May. The main reasons for the correction were the significant rise in copper and oil prices and concerns over inflation. Interest rates around the world crept higher, the US and EU raised rates whilst the UK interest rate remained unchanged.

UK

The stock market, as represented by the FTSE All-Share Index, performed well over the first half of 2006, despite a bumpy ride in the second quarter, growing by 6.1 %. Unemployment rose in the early part of the year and the Bank of England maintained its interest rate at 4.5 %. It remains cautious about the level of interest rates going forward, given the increased amount of household debt and mixed economic data. Manufacturing levels have been relatively strong but personal spending has fallen, with any growth being driven by future house price rises and the level of equity withdrawn through remortgaging. The stock market reached a five year high by the beginning of May, driven by the strength of oil and mining companies. The market then saw a sharp correction due to concerns over inflationary pressures. Despite the uncertainty over interest rates, the underlying economy remains in good shape and should continue to grow during 2006.

Europe

The European market, as represented by the FTSE World Europe ex UK Index, saw positive performance during the first six months of the year, with growth of 6.3 %. During the earlier part of the year, the European market was driven higher on positive earnings and increased corporate activity. European companies have been involved in some high profile merger and acquisition activity, including Telefonica acquiring O2 and Ferrovial taking over BAA. Business confidence picked up and unemployment has fallen. The European market was not immune to the global correction during May, but the underlying prospects for the economy remain positive for the rest of the year.

US

The US stock market, as represented by the FTSE World North American Index, fell by 4.3 % during the period. In the early part of the year, employment continued to grow and corporate profits remained strong. The US Federal Reserve (Fed) continued to raise interest rates, with many observers feeling interest rates had peaked at 5 %. However, the new Fed Chairman, Ben Bernanke, continued to raise rates to 5.25 % in June in response to the rise in underlying inflation. Markets became concerned about a growth slowdown. The shift in sentiment hit stock markets hard, resulting in a global sell-off and profit taking. Despite this, strong corporate balance sheets should leave the US economy in relatively good shape overall.

Japan

The Japanese market, as represented by the FTSE World Japan Index, fell by 5.3 % during the first part of the year. The Japanese economy had a strong 2005. The employment market continued to strengthen, consumer confidence was high and underlying inflation was positive for several months. On the back of this positive investor sentiment the stock market reached a five year high in April, but was then hit by a series of corporate scandals and technical difficulties on the Tokyo Stock Exchange. The market wasn't immune to the global sell-off in May; however, the domestic long-term recovery should continue and the Japanese market should benefit from the improving economy.

Asia

The Asian market, as represented by the FTSE World Asia Pacific Ex Japan Index, fell by 0.3 % during the first half of the year. Corporate activity continues to dominate the investment landscape, fuelling large foreign investment into Thailand and Indonesia. The Australian market continued to benefit from rising commodity markets. Asian stock markets were also impacted by the inflationary fears from the US. Investors sold riskier emerging markets during the global stock market correction in May, and this has led to an uncertain outlook for the rest of 2006.

Fixed Interest

The corporate bond market was relatively flat in the first three months of the year. Merger and acquisition activity and rumours of such activity continued to increase stock specific volatility during the first quarter. The yields on corporate bonds continued to rise during April. In the first few months of the year, global economic growth helped corporate bonds look attractive compared to their government counterparts. However, the sharp sell-off in most major equity markets around the world during May indicated an increase in investor risk aversion. This led to the slight underperformance of corporate bonds versus government bonds. The outlook for the corporate bond market remains relatively flat for the rest of 2006.

Emma Brandwood is Investment Strategist for Legal & General Investment Management

The above review is for the period 1 January to 30 June 2006 and does not reflect changes in market conditions since this date.

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The Case for Mid Caps

A repeated question at conferences and client meetings over the last few years has been 'is it all over for mid caps after such a strong run?' It's true that, even taking into account the more recent volatility in the market, returns from mid caps have been particularly strong – in the five years to the end of June 2006, the FTSE Mid 250 ex ITs index returned 82.03%, comfortably outperforming the FTSE 100 index of larger companies which returned 25.58% over the same period (Source Standard & Poor's, Bid to bid, net income re-invested) says Andy Brough.

It's human nature to think that if things have been going up and up, they are bound to come down sooner or later. So it's easy to say it's all over for oil, it's all over for China, it's all over for the housing market and it's all over for mid caps. Only, in reality, it's probably not.

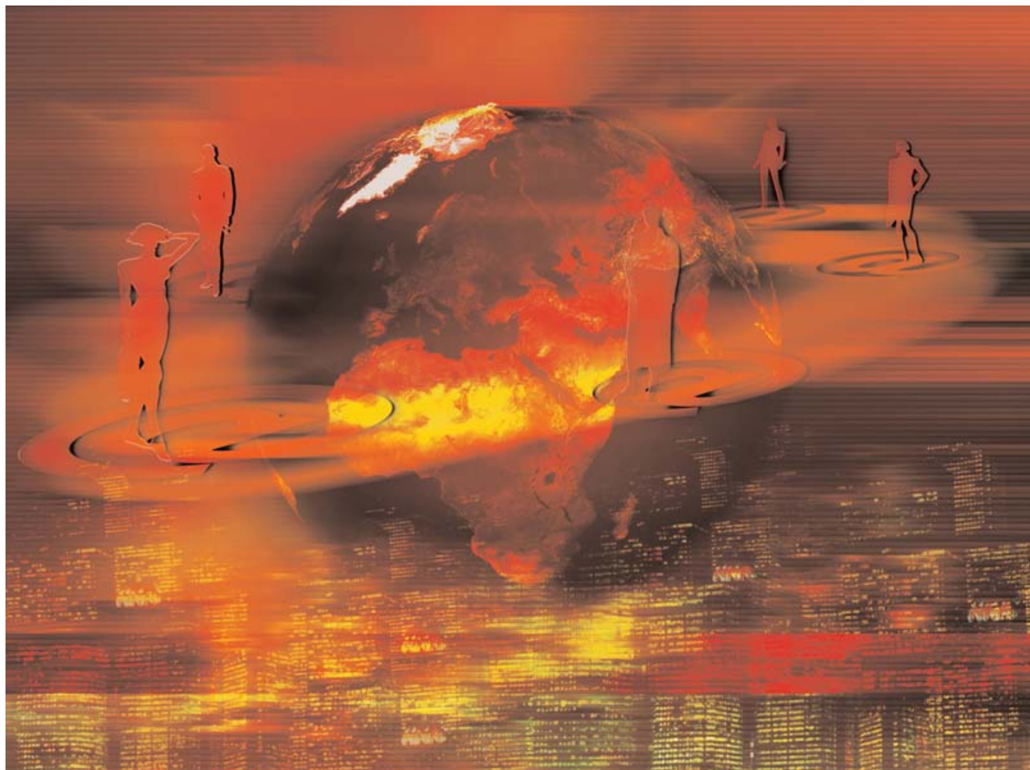
For one thing, mid caps remain a dynamic part of the market. If you look back to 1999 when at Schroders we launched our Mid 250 fund, only 85 of the companies in the FTSE 250 at that time are still in the index today. Performance gets captured as companies are acquired or advance into the FTSE 100, while other opportunities replace them from the small cap area of the market. With this level of turnover, there are still plenty of good stocks in the index and it's our job to pick them out.

Another argument against mid caps is that, given the more 'exciting' investment opportunities now available - for instance, in emerging markets - why stick with the UK? Well, for one, if your liabilities are in sterling then investment in the UK market makes sense; otherwise, you're introducing currency risk. But the UK mid cap market is also remarkably diversified, comprising a wide range of companies with varying international exposure. For example, there are almost a dozen oil and gas companies in the FTSE 250, so as demand from China and India escalates, investors can tap into the growth from these economic powerhouses without leaving the comfort of the UK market.

In fact, to revert to one of my favourite topics, the UK market can be compared to what's been happening in football over the past few decades. The UK football league has been attracting players from around the world, who want to play with those of a similarly high standard and have access to the deep pockets of cash at the big clubs. London's equity market offers large pools of liquidity that have not gone unnoticed by foreign firms - over the last year alone, more than 120 non-UK companies have listed on the LSE. Not only does this further diversify the market, but with more companies from emerging markets such as Russia and China looking to list, this liquidity also reduces the risk that would be associated with investing in the same companies in their home markets.

You also can't ignore the fact that the UK is very open in terms of merger and acquisition activity. P&O, lastminute.com and Pilkington are just a few examples of mid caps recently taken over by foreign firms and with this level of overseas interest in UK-listed companies, opportunities will no doubt continue to emerge.

Looking more closely at the market, which areas are looking most attractive right now? Well, construction has been a big theme for us for a while and is still an area we're keen on. We're particularly keen on companies connected with the government's Private Finance Initiative – examples include Carillion, Atkins, Victrex and John Laing. Not only do we have the apparent reconstruction of every school, hospital and road, but we've also got the Olympics, the second Thames Crossing, the Thames Gateway (the rejuvenation of the embankment), the Crossrail project and the new M25 lanes. With 25 year contracts, an equity stake and regular payments in return for financing the projects, winning these contracts adds real value to the companies concerned.



We're also quite interested in defence stocks at the moment, particularly Ultra Electronics Holdings and Cobham. The world is an increasingly dangerous place and

government military spending is rising - 76 defence deals took place in the US last year and while there weren't any in the UK, it's going to be coming this way.

Turning to technology, in general we don't find this part of the market that attractive. We only hold one pure IT stock – Cambridge Silicon Radio – and with the price of IT goods and services going down every year, we're not planning to increase this. However, we do still like 'tech enablers', where technology is being used to improve profitability and efficiency. Mail-order retailer Findel is one example of this - the internet now accounts for around 21% of all its orders, compared to 16% in 2004. The company has had a hard time of late, but internet retailing is certainly here to stay.

There are some quality companies in the financials space - the UK has traditionally been good at making money from money and it is not simply through mega caps such as HSBC that investors can gain exposure to this. We like Investec which offers a good opportunity to gain exposure to the UK market and the economic growth in South Africa. We also like Aberdeen Asset Management, which has performed strongly since taking over Deutsche Asset Management, and ICAP, which is profiting from volatility in markets.

So, in spite of the strong performance so far this decade and the fact that the FTSE 250 reached historic highs earlier this year, we think that investors should consider sticking with this area of the market – the dynamic and, ultimately, diverse nature of the index means that it should always be possible to find attractively-valued growth stocks in the mid cap arena.

Andy Brough is the manager of the Schroder UK 250 Fund and co-manager of the Schroder UK Mid & Small Cap Fund plc.

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The current views and opinions contained herein are those of Andy Brough, Fund Manager at Schroders and do not necessarily represent Schroder Investment Management's house view.

Investments in smaller companies may be less liquid than in larger companies and price swings may therefore be greater than in larger company funds.

Portfolios which invest in a smaller number of stocks carry more risk than funds spread across a larger number of companies.

Can't see the wood for the trees

The fixed income markets have grown over the last eight years fuelled by low inflation and abundant liquidity. The core markets have become like the trunk of a tree from which investors have branched out into riskier markets of corporate bonds and emerging markets says Paul Brain.

Consider the following:

- We have had stability at the core – government bond markets have grown 60% over last eight years

  - In a low return world investors will stray further away from their natural base (out along the branch)

- At the same time these other economies have aligned themselves to the core market policies. Increasingly, they have similar fiscal and monetary policies (strengthens the branch and allows the tree to grow)

  - Over time, liquidity gets better and markets become more highly correlated and forces investors further out (along the branch towards the end)

- Investors forced to move further along towards the edge of the branches. These fringes have grown -Investment grade +130%, emerging market sovereigns +105% and high yield +223%

But what happens when a storm comes? (the branch snaps)

The prolonged period of synchronised growth has been fuelled by a number of supports. Some of these supports are being withdrawn but others will remain, leaving some countries more vulnerable than others. The supports that have helped the tree develop are as follows:

- Low interest rates and liquidity
- Global trade
- High commodity prices
- Prudent fiscal management

Clearly the first one is being removed fairly aggressively, but there is still plenty of liquidity to go around. The next three supports are more market specific. For example, the 150% rise in copper prices over the last year has had a direct impact on exporting countries such as Chile. The rise in the value of copper has led to a 72% increase in exports last year and is one of the reasons why the current account surplus is set to double this year. Commodity prices will have to fall substantially more than their recent 20% correction to make a material dent in this improvement in credit quality.

Global growth and more importantly western growth have

had a big impact on emerging market countries and their ability to pay down debt. This is not only through the high level of demand from commodities but also from an increasingly diverse customer base. An over-reliance on one region (the US) is not healthy, and the more the regions are able to grow domestically and the more wealth that is re-cycled internally the better. The transfer of wealth from countries that need the commodities (including energy) to those that have them has led to an increased investment in domestic economies. The world still remains heavily reliant on the US consumer, but this time it is less so. A slowdown in US consumer spending will cause a global slowdown but not a recession.

Since the Asian crisis of 1998 many (although not all) emerging market governments have adopted more frugal fiscal policies. They approach this period of slower growth in a better financial position. However, there are some exceptions.

Less attractive places to invest

The growth of populist policies in some Latin American countries, such as Venezuela, Bolivia, Ecuador and even Argentina, is a cause for concern to fixed income investors. In between are countries that are vulnerable if they do not adapt such as Hungary, Turkey, Poland and South Africa. It is important to look for clear evidence that they are strengthening their roots by reducing their spending programmes and increasing revenue-raising possibilities. Hungary is a good example of a deficit reduction package that, if fully implemented, will reduce the country's reliance on international capital but will also need a response from the central bank by cutting rates. The central bank will be more inclined to let the currency decline especially if the government is able to get its fiscal measures through. This will eventually represent an opportunity but, for now, it is best avoided.

Looking ahead

In the absence of volatility, ever-increasing usage of leverage is seen as a good thing – especially for the equity holders. As long as a company can carry on servicing its debt by reducing costs and recycling cash then everyone is happy. This increase in the cost of borrowing weakens the issuer and makes it more vulnerable. In a storm, the tree will shake and the extremities will oscillate more wildly. The branches that are more vulnerable are those that are rotten inside. In the case of high yield, it is possible to find a growing number of companies that have leveraged their balance sheets without necessarily increasing their revenue streams and have weak business models. This makes them more vulnerable to an economic slowdown.

The game in the emerging market debt market has changed. Careful focus on countries with long-term improvements in their balance of payments (not just commodity froth) will prove beneficial. We will be looking for opportunities to add to our emerging market positions.

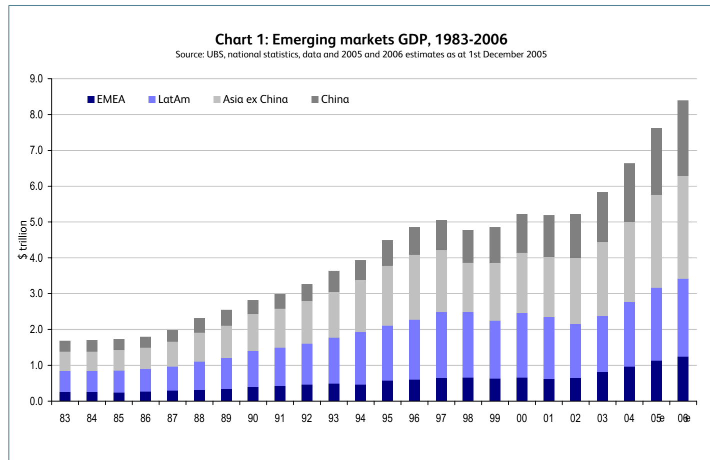
High yield corporate bonds will remain a hostage to the equity markets in the short term. Reduce individual issuer exposure, as defaults will be harder to spot.

(Source: - Merrill Lynch index data Dec 1997 to Jun 2006)

Paul Brain is the lead fund manager on the Newton Global Dynamic Bond Fund.

Latin America in Focus

Throughout the 1990's Latin America was beset by periodic crises, with most countries suffering at some point, including the dominant economies of Mexico (1994) and Brazil (1999). Investors received little reward for any faith they put in the region over that decade. More recently, however, we have seen a dramatic turnaround in the economic and corporate fortunes of the region. (See chart 1). Martin Weiss reports how in turn this has resulted in Latin America being one of the best performing asset classes over the past three years.*



Market turbulence since May has called these improved fortunes into question. The uncertainty has been driven mainly by external factors, including heightened concern over US growth and inflation prospects, which have caused investors to reassess their willingness to be exposed to riskier assets. The fundamental attractions and prospects for Latin America, however, remain strong, and as such we see recent market weakness as a healthy correction after a period of strong performance rather than the start of a bear market.

Strong stock market performance

Stock market performance has indeed been very strong. From the lows of late 2002, investment in Latin America has more than trebled, even after the recent pull-back, as the fundamental strengths and growth prospects of the region have become more apparent.

The most dramatic improvement for the region has occurred at the economic level. External indebtedness was the root cause of many problems in the 1990's, but we now see countries such as Argentina repaying their International Monetary Fund debts in full ahead of schedule, while macroeconomic management in general, with some notable exceptions, is far sounder. Current account deficits, once endemic in the region, have swung into surplus territory, aided by booming exports, buoyant commodity prices, high levels of domestic economic growth and foreign direct investment. (See Chart 2).

The result of this has been a much improved fiscal situation, appreciating currencies and rising currency reserves. Most economies are far better placed to weather any global downturn or crisis of confidence than they were in the late 1990's.

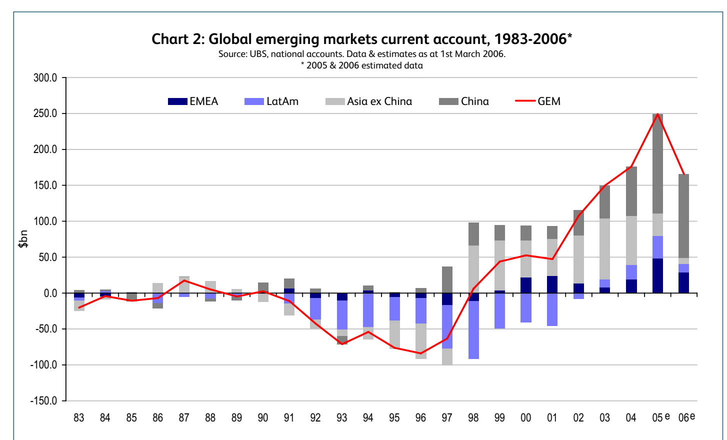
Secular improvements

The story is also positive at the corporate level, where there have been significant secular improvements, not least in terms of corporate governance. Balance sheets are stronger, cash-flows are growing and returns on equity are high. Capital expenditure discipline is much improved and shareholders are benefiting from higher payouts. Latin America yields over 3 %.*

These strong returns, along with high levels of profitability and good earnings growth, mean that corporates in the region often compare favourably with their developed market peers. The contribution from commodities is significant, and there is clearly a risk if prices fall sharply, but the structural improvements that have been made should ensure that cyclical factors, such as commodity prices, are far less important for earnings growth than they have been in the past.

Valuations still at a discount to developed markets

Valuations also continue to look reasonable, providing a further support to the asset class. Latin America, like Emerging Markets as a whole, trades at a discount of around 20 % to developed markets, despite the high returns and faster growth outlined above. Furthermore, the region



has significant longer term potential to be tapped; the population of Latin America, at 7.6% of the world,** is only slightly greater than that of the E.U., but the region's share of global GDP is less than a third that of Europe's. With a superior demographic profile as well, it is hard not to see this differential narrowing longer term.

Positive long-term view
These strong prospects, solid fundamentals and attractive valuations keep us positive on Latin America on a longer-term view. Nearer-term, though, there are some bumps in the road which need to be negotiated. Politics needs to be monitored closely to gauge the spread of populism in the region, particularly following Bolivia's shift to the left. Encouragingly, Mexico appears to have elected the more market friendly candidate, Calderon, by the narrowest of margins, but the outcome of elections in October in Brazil, the region's main power, will be important.

An even more important driver of Latin America in the coming months, however, will continue to be investors' attitude to risk. Despite local fundamentals remaining solid, Latin American markets sold off sharply in May as uncertainty grew over the outlook for US, and by extension global, growth and inflation. Uncertainty over how aggressively the new Fed Chairman Ben Bernanke will set interest rate policy – and generally tighter global liquidity conditions are also an issue.

Latin America remains an attractive region to invest in for the long term investor, but until it becomes clear that the outlook for the global economy really is benign, markets in the region as a whole are likely to remain volatile.

Martin Weiss is Product Director for Invesco Perpetual.

* Source: Invesco Perpetual. 30th June 2006.

** Source: CIA World Fact book.

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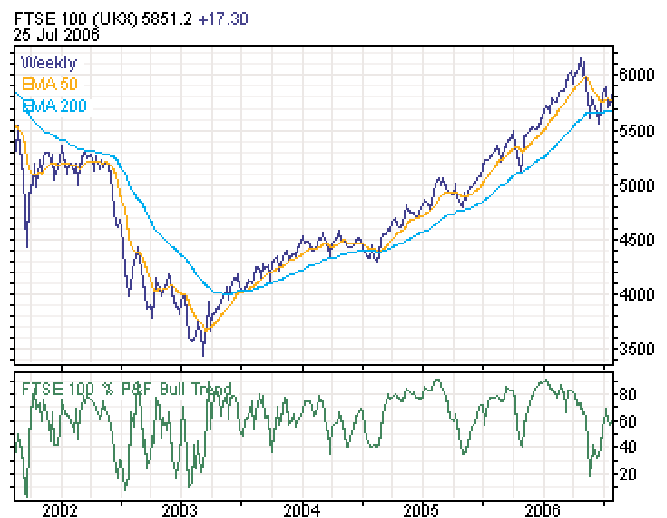
Further consolidation needed?

The May sell-off for the FTSE100 surprised many traders and investors with the severity of the move reports Mark Glowrey.

The 10.9% pullback was enough to test the 200-day moving average and revert our 50-point 3-box reversal P&F chart back to "Bear" status, having hitherto held an unbroken pattern of rising reaction lows from the spring 2003 lows. Behind this index move, the change in breadth characteristics was also notable. The 2003-2006 bull run was characterised by index breadth (i.e. the number of constituent stocks within the index holding uptrends) ranging between a well-defined 40% and 90%, with the



lower end of this range providing a good timing signal for accumulation (see bottom window of chart, above).

The May sell-off saw the bottom of this range violated, indicating that this move was more severe than the previous countertrend reactions seen over the last few years. Since then, the index has seen some stabilization, with ranging occurring between 5,550 and the recent recovery highs around 5,900. We take the view that the severity and breadth of the May pullback will have impacted investor sentiment, and further consolidation/ranging will be required before direction is re-established. On a more positive note, the three-year uptrend remains the primary, or underlying, trend for the market, but this may not reassert until Q4.

In our January report for Stocktake, we highlighted the technical situation of mid and smaller-cap stocks, noting the overextension in the then strongly performing FTSE250 and

the potential resistance for the Small Cap Index from the millennium highs. The FTSE250 went on to extend these gains while the Small Cap did indeed fail at the previous peak, following a quick nudge above the prior highs.

The situation now shows the FTSE250 turning to underperformance, as measured by the relative ratio to the FTSE100. This indicates a lack of appetite for risk from UK investors, and ties in with the cautious scenario illustrated above. Further evidence of this aversion to speculative/growth type stocks is seen from the relative performance of the FTSE AIM index, which is moving to a relative downtrend against the blue chip FTSE100.

Our view remains a relatively cautious one over the summer months. Longer-term investors should use further weakness to accumulate value in selected blue-chips, but we are wary of exposure to small caps.

Mark Glowrey is Director of Investors Intelligence

Selftrade customers can view daily updates, charts and analysis tools from Investors Intelligence on the Selftrade website. Go to “Market Focus” and select “Research” or simply click on the Investors Intelligence logo visible on the right hand side of your account summary.

Bonds and ISAs… the perfect match?

Much attention is paid to using the tax-free structure of an ISA in order to avoid capital gains tax, but in truth, the majority of investors are remarkably untroubled by capital gains liabilities and are able to book most of their profits below the £8,500 (2005-06) personal tax allowance says Mark Glowrey.

The real power of the ISA structure comes from the ability to receive income free of tax. Compounding this over time is an engine of growth for the private investor, thus making income-producing securities ideal for such a vehicle.

So why not buy bonds? These instruments typically produce a higher yield than equities, are generally lower in risk and provide a diversification play from the equity markets, often performing defensively over market downturns.

One problem about bonds, compared to equities is the limited upside. From time to time, an investor might pick a Microsoft (up a multiple of over 70 times in the 1990s) or Cairn Energy (7 times in this decade). These kinds of dramatic gains make taking a risk worthwhile and pay for a number of mistakes and disasters on the downside. However, with bonds, upside is more limited and the “best case” scenario is usually a pedestrian redemption at par with all coupons paid. The limited upside means that investors generally pursue a more risk-adverse strategy when dealing in the bond markets, and minimize risk to capital by selecting debt from high-quality instruments.

The most secure type of bonds are government issues, known as Gilts in the UK. This type of investment provides a cast-iron guarantee for the return of your money, but accordingly, the return will be low, sometimes below that available on a deposit account. Perhaps a better compromise is corporate bonds, issued by large companies to raise longer-term finance. As with shares, these type of investments cannot be said to be risk free. Given this additional risk, the yield available from this asset class will be higher than that achieved from the super-secure Gilts, however it is worth bearing in mind that bonds rank ahead of equities in the event of corporate bankruptcy and in absolute terms, failure or default for the higher rankings of bonds is a comparatively rare event.

Timing and selection

So what sort of bonds should one put in an ISA? Taking a

Inland Revenue Rules: Bonds eligible to be held within an ISA fulfil two characteristics. Firstly, the bond must be either listed on a recognised exchange or be issued by a company, the shares of which are listed on a recognized stock exchange. Secondly, the bond must have a maturity of five years or more and without an early redemption option.

conservative view to lower risk, fund managers would generally limit themselves to "investment grade" bonds. These are bonds issued by companies (or other organizations) which are rated BBB or above by one of the international credit rating agencies such as Moody's or Standard & Poor's.

Timing is a more delicate art. Obviously, investors will wish to buy bonds when yields are higher, and enjoy capital appreciation as rates fall and bond prices rise. Pragmatically, it will be difficult for even the most experienced fund manager to achieve this consistently over time, although there are undoubtedly rises and falls in rates that can be taken advantage of. A more realistic approach would be to devote a proportion of each year's ISA allowance, averaging into the peaks and troughs and building a diversified portfolio as you go. A sensible approach would be to hold these bonds until the redemption date, thus maximising the income flow and minimising dealing costs.

A well structured bond portfolio should spread the risk across different issuers. Ideally we would also like a broad spread of maturities, but the ISA rules (see below) dictate that we can only buy bonds with a maturity of five years or more. With this in mind, here are three chosen from the selection available on the Selftrade dealing platform:

Marks & Spencer 5.625 % March 2014*. One of Britain's best known retailers with a solid business. Rated BBB by Standard & Poor's, the bond is towards the bottom ranking of our credit criteria, mainly due to the potential threat of another leveraged takeover. Currently priced just under par at 99.46, the bond gives a yield to maturity of 5.71 % **.

Severn Trent 5.25 % Dec 2014: Rated A by Standard & Poor's (although subject to a potential downgrade), the credit is two notches above the M&S bond. Priced at 99.55, this utility company's bond gives a yield to maturity of 5.26 %. For comparison, the dividend yield on the company's equity is 4.28 %.

BAT International Finance 5.75 % Dec 2013: This tobacco company's dept is rated BBB+ by Standard & Poor's, one notch better than the M&S issue. Trading at around par in the market, investors will receive a yield equivalent to the coupon rate of 5.75 %.

Mark Glowrey is director of Investors Intelligence, a division of Stockcube Research Limited, authorised and regulated by the FSA.

For more from www.investorsintelligence, see the daily technical analysis updates available on the Selftrade website.

* The standard convention for describing bonds, is issuer (eg HBOS), coupon (eg 5.75 %) and then finally the date of maturity (eg 15th October 2010). Hence HBOS 5.75 % Oct 2010.

** The yield to maturity (or Gross Redemption Yield) is a calculation that takes into account the total return on the bond, both from the interest received and the capital gain/loss between purchase and maturity.

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