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Axiomatic Investment for the Pre-Teens

During the summer news lull strategists have spent a lot of time trying to draw comparisons between our current situation and other periods of economic uncertainty. Starting with broad generalisations about the 1970s and the 1930s they have moved on to specifics including the banking crisis of 1914 and what exactly happened in 1937. All very interesting, but as a battle-weary fund manager said to me recently, a discussion best reserved for the dinner table.

Of more immediate interest is to look at the factors that may drive investment markets during the period 2010-12 or pre-teens. If Christmas decorations can be put on display in August, I can make New Decade predictions in September.

The impact of demographic trends on investment markets remains a dominant theme. Hence our recent Generation Y initiative at Cheviot. Generation Y are those born since 1978, all of whom grew up with the internet. They may be getting ready to take charge, but so far as investment markets are concerned Baby Boomers (1946-1964) are still in the driving seat both as spenders and savers. Their priorities will continue to drive markets for a few more years yet.

Now for the axioms with the emphasis on self-evident truths rather than established principles. Boomers may reach for the dictionary at this point. Generation Y will either have stopped reading or checked the definition on their iPhone.

- The risk-free rate of return will remain close to zero - for example, short dated Government bonds and deposits at reputable banks.
- Governments will underwrite corporate risk for as long as they can afford to and will do nothing to disturb the recovery. As a result interest rates will remain low for years rather than months.
- Globalisation is here to stay and will affect all parts of our lives. In particular it will ensure competitive pricing of manufactured goods and services thus keeping inflation under control. Scarce resources are another matter.
- The savings rate will continue to rise both because of the impact of the credit crunch on our collective attitude to risk, but just as powerfully because of the growing realisation that only those fortunate to work in the public sector (approximately 6 million in the UK) can feel confident about their pension reserve. Late boomers are particularly sensitive to this having been dumped out of final salary schemes in their 40's.

U.K. SAVINGS RATE 1960-2009

Source: Bloomberg

- Capacity utilisation will remain below average because of over investment during the last ten years when credit was easily available.

  As a result downward pressure on economic growth and inflation will continue. We would need to get back to 80% before celebrating a return to growth.

US CAPACITY UTILISATION 1967-2009

Source: Bloomberg

- GDP volatility will be higher than has been experienced in recent years. This is not surprising considering we are now in a period where governments are the dominant factor in economic growth. Political expediency and the electoral cycle will outweigh the decisions of individuals and business.

U.K. GDP 1955-2009

Source: Bloomberg

If, for example, we apply these axioms to UK equities it seems likely that many companies will find it hard to increase profits and so those that do will command a higher premium than at present.

Dividend paying companies will also be in greater demand and will be re-rated. Note the importance of a few large companies.

Top Dividend Payers	% of total UK dividends Source: FT	Estimated yield % Source: Bloomberg
BP	12.3	6.94
Royal Dutch Shell	12.1	6.44
Vodafone	7.4	6.09
HSBC	6.4	3.22
GlaxoSmithKline	5.6	5.01
BHP Billiton	5.3	3.26
AstraZeneca	3.8	4.98
BAT	3.3	5.09
Tesco	1.8	3.46
National Grid	1.6	6.58
Diageo	1.6	3.94
Unilever	1.5	4.21
Standard Chartered	1.4	2.89
Imperial Tobacco	1.3	4.28
Aviva	1.2	5.27
Reckitt Benckiser	1.1	3.21
Scottish and Southern Energy	1.1	6.36
Centrica	1.1	5.05
SABMiller	1.1	2.72
Rio Tinto	1.1	1.33
Total	**72.1%**	**Average 4.52%**

There will be investment opportunities in many other asset classes with active strategies better placed to benefit than passive. Investors will have to take risk to earn a return. This may sound obvious but in 1990-92 during a previous recession interest rates averaged 12% and so there was far less pressure to invest than now.

As we move on from the credit crunch short term fluctuations will, as ever, be driven by the broad spectrum of influences that occupy us on a day to day basis whether it is short term profit taking, the decline in the Baltic Dry Index, optimistic consumer confidence surveys, director buying/selling or the unknown unknowns. It will, however, be an understanding of the underlying investment drivers that will lead to superior returns as the solemn process of recovery is slowly enacted.

Excitement for mathematicians comes from disproving generally accepted axioms. Investment managers do the same, constantly testing their views against the facts. If I had to identify the central support for financial markets it is that inflation will remain moderate. A big move in inflationary expectations would be the catalyst for radical change.

8th September 2009

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