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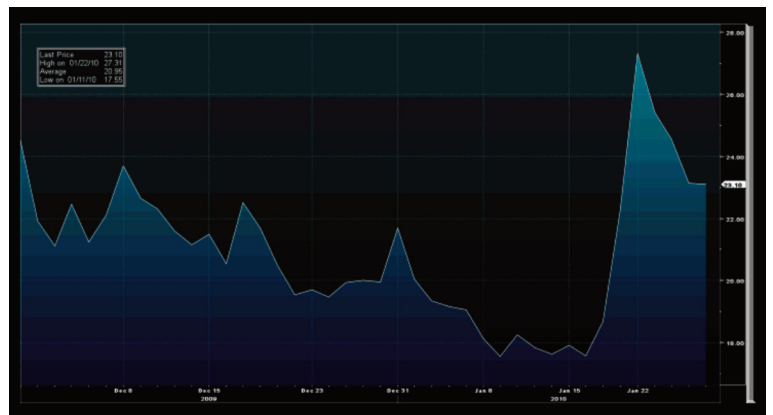
The Old Year and a Few More Weeks

"The true state of every nation is the state of common life".

Dr. Johnson

Just as the flood of optimistic New Year forecasts started to subside, risk moved back up to the top of the agenda and what did well last year was hit by sustained selling. Market volatility increased by over 50%.

Market Volatility (VIX) December 09 – January 10



Source: Bloomberg

The twin pillars that had supported markets in 2009, suffered a one-two punch when the Chinese tightened up on bank lending and then the day after President Obama announced plans to restrict the trading activities of US banks. Bearing in mind that financials and resource stocks account for 50% of the UK market, it is unsurprising that the index buckled.

Before we close the books on 2009, it should be remembered that the returns achieved were a lot better than might have been expected. A combination of cheap and readily available liquidity, together with depressed valuations, overcame concerns about the stability of the financial system.

Recent market movements

Equity Indices	Recent High	Subsequent Decline %
World	14th January	-5.3
UK	11th January	-5.5
USA	19th January	-5.1
Eurozone	8th January	-7.6
China	23rd November	-10.5
Hong Kong	16th November	-12.7

2009 Returns

	%
Global Equities	+23.5
Gold	+24.4
Hedge Funds	+20.0
UK Government Bonds	-1.2

Investment management involves a combination of judgement and calculation. The relative importance of each is dependent on market conditions and does change. Towards the end of last year I was involved in a discussion involving fund managers from a number of leading private client firms. It was striking that, despite the huge upheaval in markets over the last two years, the approach of many had hardly changed.

Up until February 2007, financial markets behaved like clockwork and investors grew used to a steady and reassuring tick in the background as they went about their daily business. It was assumed that markets were efficient, diversification worked, correlations between asset classes were stable and that credit was always available. Then there was a murmur at the heart of this well ordered world emanating from HSBC's US mortgage business. Sub-prime entered the public domain. After a brief period of concern, the system settled and markets recovered to pre-murmur highs. Then, in late July/early August 2007, when most respectable movers and shakers were on the beach, the first major shock occurred. Quant funds, which manage money on a systematic numbers driven basis started to lose a lot of money. The normally predictable Goldman Sachs Alpha fund declined 11% in July and, by mid August, was down a further 16%. It was clear that a significant liquidation was taking place as risk aversion increased and short term traders all headed for the exit at the same time.

More than two years on, so much has changed. To select a few statistics from the encyclopaedia of amazing facts;

- In 2009, China committed \$600 billion to a huge stimulus package.
- Despite government intervention amounting to \$800 billion, US money supply increased by only 0.7%.
- US credit card debt fell in December for the first time ever as consumers became savers.
- All major economies suffered short sharp recessions ranging from -4% in the US to -8% in Japan.

Yet many investment managers continue to operate using systems developed for the old world. In part, this is because expensive, highly engineered business models develop an internal support system that suppresses innovation. Just too much capital – monetary and political – has been expended for there to be an acknowledgement that change is needed. Private Banks, which have tried to industrialise private client advice by divorcing fund managers from those in contact with the clients, have found it particularly hard to adapt. Many use optimisation models to create easily understood recommendations presented with a level of certainty that is comforting and dangerous in equal measure. Heroic assumptions are made, such as that correlation remains constant over time. If the experiences of the last two years have taught us anything, it is the opposite of this. Simplifying to explain is a good idea, but understand the risks.

The way in which client questionnaires are used is also of interest. A lot of effort is expended collecting information about objectives, constraints and attitude to risk. Yet the end result, the client's portfolio, is hardly ever tailored to meet anything other than the broadest classifications. The gap between the marketing words and the appropriate investment tools was always there but has widened as market instability increased.

In the real world it is clear that;

- Private investor's time horizons differ.
- Liabilities are hard to pin down. Even well organised people with clear plans can be blown off course by unexpected events.
- Inflation, which has been dormant for years, can no longer be air-brushed out of the decision making process. Real returns matter more than nominal.

The majestic clockwork, which ran uninterrupted during the years of falling interest rates, low inflation and easy credit will, with hindsight, be seen as an usually benign period.

I am reminded of IBM's efforts to build a chess machine that could beat the world champion. Big Blue took on Gary Kasparov for the first time in 1989 and lost. In 1996 he won again but, for the first time, lost a game. Finally, in 1997, the computer won. What changed over those eight years was, of course, an increase in computing power but, just as importantly, the machine learnt to spot idiosyncratic bluffs – something humans, even chess grand masters are capable of.

Chess is a two dimensional game played between two people over 64 squares. The idea that hugely complicated financial markets involving the actions of six billion people can be simplified and explained by a few rules is absurd. It is far safer to rely on smart fund managers. Time horizon, liability drift and inflation need to go into the mix when constructing an investment plan as well as judgments about what financial markets will deliver and how best to diversify risk. That is what experienced fund managers operating in the right environment do.

So, are there any constants in this volatile world? Valuation and growth potential remain the corner stones of successful investment. A commitment to research adds value, as does attention to liquidity, cost and tax. Our approach is to diversify across a wide range of asset classes and look to add value in each one. To do this involves concentrating on the future and not the past. Risk management is an equal partner with opportunity. For example, analysing the sensitivity of our clients portfolios to possible changes in interest rates and inflation; two factors that are likely to dominate markets this year.

The events of the last two years present investors with many opportunities to earn superior returns. Portfolio construction and stock selection should be based on judgements about what financial assets may deliver and a clear understanding of objectives. Real life rather than theory.

David Miller

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