

Investment Newsletter

May 2011

equilibrium
asset management

Paying Dividends

We are facing the most dramatic squeeze on living standards since the 1920s.

That's the view of Mervyn King, the Governor of the Bank of England. In January he warned that by the end of 2011 real wages, which are adjusted for inflation, are expected to fall to 2005 levels. In other words, prices have risen significantly more than wages.

Oil prices have had a major impact on the rate of inflation. They are also one of the easiest measures of inflation to monitor, as rising prices are illuminated on 20 foot high signs at petrol pumps!

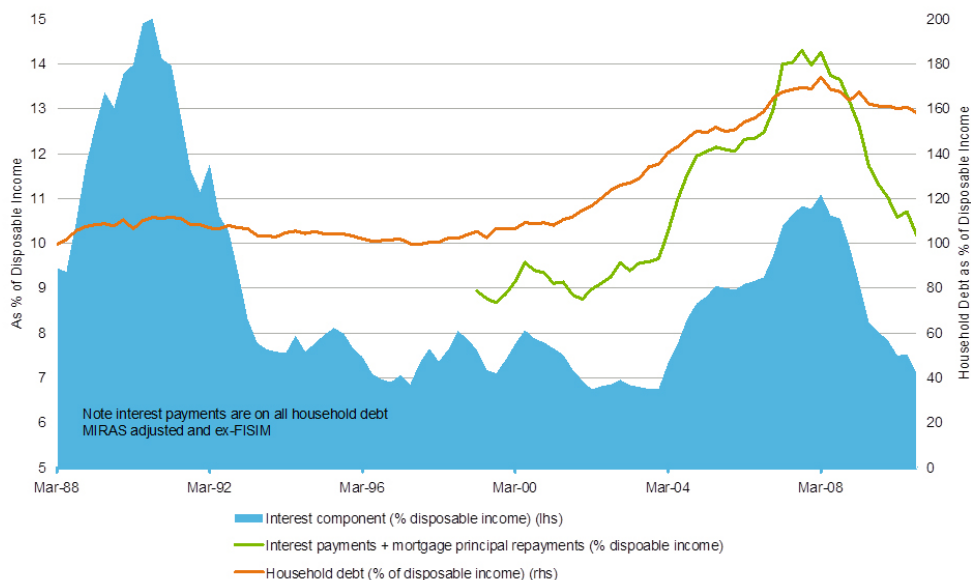
In addition to oil, food (often exacerbated by increased petrol prices), cotton and energy costs have all been subject to massive recent price rises. Further price pressure results from the increase in VAT from January this year.

Interest rates, which have been at 0.5% since March 2009, have kept the value of sterling low. This is good news for our exporters but increases the price of bringing foreign goods into the country, a further inflationary influence.



Debt

With wage increases low, the overall effect of high inflation is less disposable income for the UK consumer. This does little to help relieve levels of household debt which remain at near record highs, as shown on the chart below:



The orange line on the chart demonstrates a clear long term trend for UK consumers to increase levels of household debt relative to disposable income.

The blue area shows interest payments made on household debt relative to disposable income. An example might be payments on an interest only mortgage where the debt is serviced but no principal repayments made.

The green line shows interest payments made on household debt plus repayment of the principal mortgage, relative to disposable income.

This consumer debt has not fallen despite 2 years of interest rates at just 0.5%. Low interest rates should offer an opportunity to repay debts as interest repayments are low. But with high inflation causing living costs to soar, consumers are clearly unwilling or unable to payback household debt.

The Bank of England's Monetary Policy Committee (MPC) is charged with the task of controlling inflation. They do this by setting interest base rates. Historically as interest rates go up, economic growth slows and inflation falls.

One of the problems currently facing the MPC is demonstrated by the above chart. Inflation has been consistently above the 2% target since late 2009. Raising interest rates may help combat this, however an increase in interest rates now while household debt (orange line) is so high may well result in unmanageable interest payments (blue area) at a time when consumers are already struggling to make ends meet.

UK consumers aren't alone in feeling the pinch. The Government is grappling with an unfathomable mountain of debt - Britain will pay interest of £43billion this year alone.

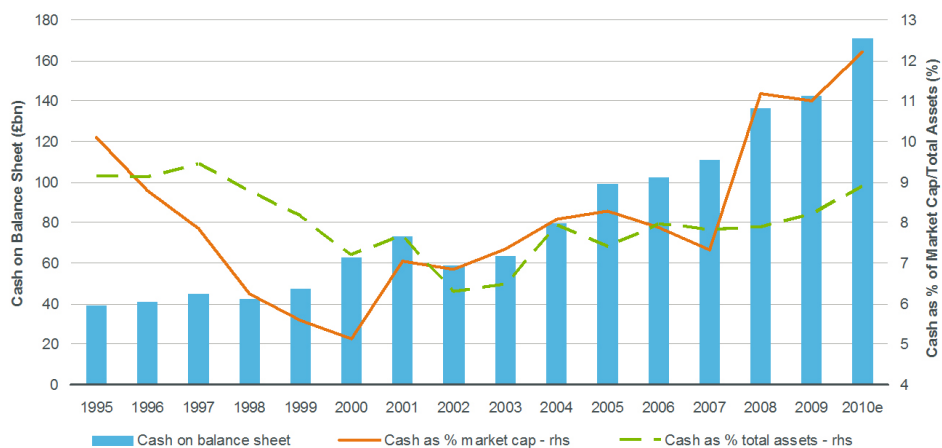
At the end of December 2010 general UK government debt was £1,105.8 billion, equivalent to 76.1% of GDP. This was up from around 45% at the end of 2007.

So with the UK Government and consumers both heavily in debt, where is all the cash?

Corporate Cash

Some of it looks to be with large UK companies who are faring fairly well despite the recent global crisis.

The following chart demonstrates that large UK companies (all companies in the FTSE 350) have increasingly high cash levels, shown by the blue bars.



The orange line looks at cash levels relative to a company's market cap (market cap is the total market value of all shares a company has issued). The green line shows cash relative to all other company assets.

Overall it is estimated that UK listed companies are sitting on £170 billion of cash, equivalent to 12% of market cap.

The rude health of corporate balance sheets was also noted in the MPC's most recent inflation report which pointed out "Private domestic demand growth could be boosted if more of the historically large corporate financial surpluses were spent on capital investment or transferred to households in the form of higher wages or dividends."

This is backed up by several conversations I have had with fund managers over the past few weeks. The consensus view is that cash rich companies, who are receiving negative real returns on cash in bank accounts, will shortly look to utilise their capital, possibly by increasing dividends.

This distribution of cash may already be underway. In an article on 18 April Simon Read, Personal Finance Editor for the Independent, pointed out that "Payouts by UK companies soared to £15bn in the first three months of the year, rising by 10.3% compared to the first quarter of 2010".

These large cash positions are also expected to prompt merger and acquisition activity, a driver of stock market prices.

Equilibrium Positioning

This supports our current position at Equilibrium.

Last year we increased weightings in our UK Large portfolio. This portfolio includes funds that invest in shares of large UK companies who historically have paid above average dividends.

If companies do start to utilise their capital, we are confident that this change will pay dividends.

Andy Baker
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GDP growth is expected to remain muted but has recovered from last quarter's negative result. Inflation may remain well above the Bank of England target for some time. It may fall back this year, but not as far as some have predicted. Oil prices have fallen back but remain high, and these could impact on global growth if sustained.

We believe interest rates will rise this year, but now probably only by 0.25%. This will have little impact on inflation, driven by external factors. We think inflation could be an issue for some time.

If our scores below turned out to be correct, our balanced asset allocation could return around 7.5% over the next 18 months compared to our long term assumption of 7.6% pa.

Asset class key

+ positive	+5 strongly positive
- negative	-5 strongly negative
= neutral (normal behaviour)	

	Outlook
<p>Equity Markets</p> <p>Equities have recovered from their mid March dip which made them look very cheap. They now look reasonable value based on current earnings. However, the consensus is for some decent earnings growth this year and based on earnings estimates there is the potential for some good growth.</p> <p>We believe that high quality, well capitalised companies should outperform, as they have not seen the same growth as poorer quality stocks.</p>	+1
<p>Fixed Interest</p> <p>We are concerned about the risks of investing in pure fixed interest. Given our views on inflation and interest rates, returns on fixed rate bonds are likely to be much lower than they have been of late whilst the risk of losses is increased.</p> <p>However, we believe there is value in inflation linked, variable interest rate, and some high yield bonds.</p>	-4
<p>Commercial Property</p> <p>The rental yield on the commercial property index remains attractive relative to other asset classes. However, we are expecting little capital movement and possibly some small capital losses over 18 months.</p> <p>Property funds are gradually reducing their high cash levels, which has been a drag on returns. This should improve total returns in the long run but in the meantime we are expecting lower than average returns.</p>	-4
<p>Residential Property</p> <p>We believe prices could fall or remain flat over 18 months, well below our 5% pa average assumption.</p>	-5
<p>Cash</p> <p>With interest rates remaining at record lows, returns on cash are as low as they have ever been. Rates will remain below average for some time.</p>	-5

These represent Equilibrium's collective views. There are no guarantees, although we hope to be right more often than wrong. We usually recommend holding at least some funds in all asset classes at all times and adjust weightings to reflect the above views. These are not personal recommendations so please do not take action without speaking to your adviser.