

Of Cretans' cares

What do you do?

A paradox of the ancient world, very apparent in these troubled times, was expressed by way of Epimonidas the Cretan.

He says: "All Cretans are liars." If he is lying, he is telling the truth. If he is telling the truth, he is lying.

You, by contrast, are probably not a Cretan. Indeed you may never have been to Crete, or even to anywhere near it. What you are is an investor, facing a statement which probably shows some unappealing returns. And with the financial press everywhere reporting the demise of credit and the death of capitalism, it is tempting to pack up, sell all your investments and retreat to cash – and/or to Crete, possibly at the same time.

This urge may remain - or indeed grow - in the coming months. There are, we think, a number of forces at work which are conspiring to make an admittedly difficult situation seem terminal. But in our view, while we are not about to deliver abundant good news, we feel that the negative sentiment is overdone.

Premise, promise, conclusion ...

There is now little doubt as to the causes of the current problems. However innocently, banks have once again lent unwisely - as they always do at some stage in the cycles through which economies and stockmarkets turn.

But this time markets (and good old human nature) have allowed banks to lend on a scale worthy of Minos, King of Crete, he who kept a Minotaur, built himself a labyrinth and so on. Caught up in labyrinthine acronyms like CDOs (collateralised debt obligations) and such things, let alone sub-prime mortgages, banks' balance sheets look as if they have been audited by Epimonidas the Cretan. The result, leaving aside all the technical jargon and numbers, is a collective, comprehensive and chilling lack of confidence.

This is expressed through 'tightening' in the supply of credit. Companies and investors with cash are cautious about lending to banks, and banks are reluctant to lend to each other or to customers. If they do, it is at a much higher interest rate than before. So credit, which oils the economy, is not only in a short supply but has become very expensive.

From the general – to the particular ...

An example of that 'tightening', much closer to your homes and ours, is mortgages. We've all seen interest rates coming down – but mortgage rates going up. A recent survey of more than 300 Citizens Advice Bureaux across England and Wales found a 35% increase in mortgage difficulties in January and February, compared with 12 months ago. Hence the eloquent term, much bandied about, 'the credit squeeze' or, as it's called more commonly these days, the 'credit crunch'.

A corporate example of much the same thing is BAT, the tobacco company. Whatever your view(s) of tobacco, BAT's lungs and respiratory systems are fit to run, and even win, a marathon. It is a well financed, well diversified, strong business. It chose to borrow some money recently - and current conditions forced it to pay 7.25%, compared with comparable government bonds yielding 4.5%. That is, investors were being offered an additional 3.75% for lending to BAT. This is smokey. On these terms, would you lend to BAT or the government? In our view, BAT wins by a mile.

So cash and government bonds offer low returns compared with bonds and equities. We think that this flight to risk-free returns will prove mistaken. It is driven more by fear than by economics. The selling of equities has been indiscriminate, failing to distinguish between the good and the bad.



Source: The Daily Telegraph 2008

Angst and apocalypse ...

There is no doubt that, with a slowdown in economic growth, there is the likelihood that some companies (and lenders) will struggle. But current prices are anticipating an apocalypse. So if that seems exaggerated and irrational, why has it happened?

There are a number of reasons. Banks and insurance companies are the major holders of bonds. Both are regulated (of course), and have to hold a certain amount of capital or reserves against the assets they own. The riskier the asset, the higher the amount of capital backing required. So far, so good.

A measure of the riskiness of a bond is provided by the rating agencies who (for a fee) give a view

as to the creditworthiness of a bond or an entity. AAA (for example, British government bonds) is, supposedly, the least risky, and so on.

The rating agencies are feeling persecuted at the moment: the US sub-prime crisis has suggested that they have been too generous (aka plain wrong) in their assessment of risk. That is why they are now taking a much more cautious line. But is it after the horse has bolted?

If a bank holds a bond that is 'downgraded' by an agency as deemed to have become risky, then the bank's options are limited: put up more capital/reserves against the holding, or sell it. Some financial institutions, being short of capital, have chosen to do the latter. In a nervous, illiquid market these forced sellers have driven prices down to the current depressed levels. The proceeds of these sales then have to go into the 'safe haven' of government bonds to improve the financial position of the bank or insurance company – and so the cycle turns.

The banks are also feeling persecuted because investors are coming to sense a major flaw in these institutions' business model. The rating agencies are paid by the bond issuers to carry out the ratings. But they are not accountable to, or paid by, those investors who rely on their reports.

Forced to fall ...

The second factor at work has been the impact of 'leverage' – more commonly known as good, old-fashioned borrowing. Some bond and equity funds

– though not unit trusts like ours, which (fortunately as it turns out) aren't allowed to – have invested using not only the funds entrusted to them, but also borrowings against those funds.

This is fine when everything is going up. In falling markets, funds receive redemptions from investors and are forced to sell into a falling market. There is good evidence to suggest that there have been a number of such 'forced sellers' recently.

As we write, a substantial fund which invests in bonds is selling assets to stay afloat. It is being pressured to sell assets because of a fall in its value, which in turn has prompted its investors to want out and its banks to demand tougher terms for credit. Why are the banks involved? Because this hedge fund has borrowed about five times the value of its investors' capital in order to generate, supposedly, more exciting returns. It did precisely this, giving investors a return of 87% in 2007 – all lost in the current year. This is not an isolated case. There are people selling not because they want to, but because they have to.

So there has been a see-saw from riskier to safer assets. The resulting prices, in our view, fail to reflect the economic risks and rewards.

And another thing ...

A third factor is the influence of investors who have sold a stock or a bond in the expectation that there will be bad news, that the price will fall and that they can then re-purchase at a lower price and a good profit – so-called 'shorting' of stocks or bonds (or, for that matter, anything).

Today's sophisticated financial markets have allowed shorting to thrive. In the equity markets, some companies are undoubtedly experiencing tougher times. But the response of share prices has often been very severe and, we think, exaggerated. Modestly valued shares have fallen to a level where traditional valuations look very low compared to history. In these instances, there is no question about whether we are in recession or not: these shares are already anticipating a major recession.

But enough of these musings. A lengthy explanation of 'the state we are in' is no good unless we have some (bright) ideas as to how it might change. Do we?

Futurology ...

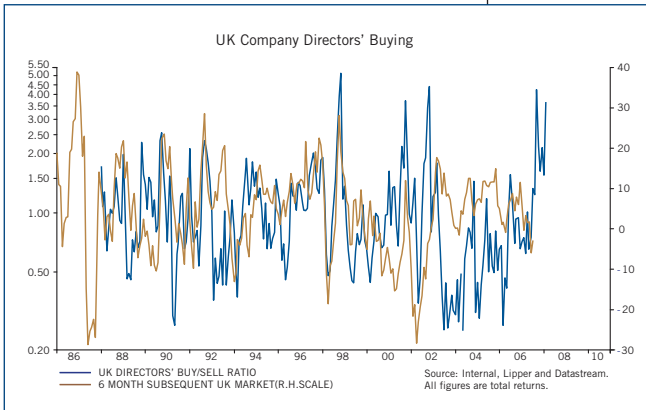
All right, the valuations of bonds and equities are low. But what is lacking is confidence. We feel strongly that, although at the moment nobody is prepared to take the lead, a catalyst for change will emerge. Prices will rise. The current situation is likely to reverse sharply, and investors will look back and wonder why they hesitated to buy at such valuations.

Central banks are recognising the need to restore confidence – the USA more so than Europe. They are cutting interest rates and trying to engender what the Edwardians, if not the Cretans, would have called 'bottle' in the lending markets.

Prices are changing, in that returns on risk-free bonds look meagre. In time, this will encourage the search for higher returns, leading to a recovery in attitudes to risk.

“The situation is likely to reverse sharply, and investors will look back and wonder why they hesitated to buy at such valuations.”

An important factor in our (guarded) optimism is that, as the chart below shows, company directors are consistently, week after week, buying many times more shares in their companies than they are selling. This, in our view, is a critical indicator that markets are over-sold - and, incidentally, is an important component of our SMARTGarp™ stock screening tool.



Meanwhile, there are many shares whose starting yield is above that of government bonds. There are many corporate bonds whose yield is 1.5 times that of bonds and cash. This is indicating a massive mis-pricing – and one which has yet to be reflected in stock prices.

Finally, there is a lot of money riding on a disastrous outcome for stocks. Were things to

prove less severe, then these “short” positions would be repurchased. That in itself would lead to a rise in prices.

We expect the negative sentiment to persist for a while yet. The statistics on house prices virtually ensure that by April/May, year-on-year prices will be negative. This will not escape the notice of the headline writers. Certain companies are not in a strong position to cope with a tougher economic environment and higher costs for debt. So, no doubt, we will see some notable failures. But again, the market is pricing (too) much of this into its thinking.

And back at the ranch ...

Finally, another area where we are looking for improvement is in the performance of Artemis' funds. Over the last 12 months the performance of several of our funds has been below our – and your – expectations and below our long-term record. We are well aware of this on a day-to-day

basis and also because, as investors in our own funds, we receive the same statements as you do.

We have been reviewing and refining our investment process to reflect these very volatile conditions and get our performance back, in the funds which have slipped, to where you and we want it to be.

History is clear that, over the longer term, equities outperform other forms of investment. We have a robust record which proves we can pick the right stocks. We aim, in six months time, to be writing to you with statements showing better and more consistent performance. Achieving this is our enduring concern, and ever-present care.

The Artemis range of retail funds was designed and is managed for longer term investors. Those of our investors who have held units for some years have seen good gains - despite bouts of volatility from time to time. We believe firmly that this is not a time to panic. It is a time of opportunity.

Risk Warning

Please remember that past performance is not necessarily a guide to future performance. The value of an investment and any income from it can fall as well as rise as a result of market and currency fluctuations and you may not get back the amount originally invested. In particular, there can be no assurance that capital appreciation will occur in the early years as initial charges are levied on your investment and charges are not made uniformly throughout the life of your investment. Artemis Fund Managers Limited does not offer investment advice. We recommend you seek investment advice from a Financial Adviser before making any financial commitments or investments. For your protection, telephone calls are usually recorded.

ARTEMIS & *The Profit* HUNTER

SHY by nature and remarkably fast, the Profit is a notoriously elusive creature. Indeed to flush and bag one of these magnificent beasts takes a hunter of particularly rare ability. Like the Artemis Profit Hunter.

BLESSED with instinct and agility, these experienced hunters like to go after large Profits wherever they may be, unlike their bigger peers who are consigned to tracking scruffy Profits along well-worn paths. This independent style of hunting has certainly paid dividends with the Artemis Hunter able to return some of the best Profits around.

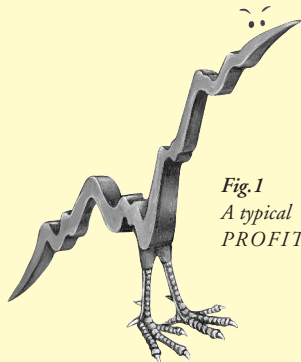


Fig.1
A typical
PROFIT

Artemis Fund Managers Limited

Cassini House, 57 St James's Street, London SW1A 1LD
42 Melville Street, Edinburgh, EH3 7HA

Telephone 0800 092 2051

Facsimile 020 7399 6497

Email investorsupport@artemisfunds.com

Web www.artemisonline.co.uk

This document is issued by Artemis Fund Managers Limited, which is authorised and regulated by the Financial Services Authority (www.fsa.gov.uk), 25 The North Colonnade, Canary Wharf, London E14 5HS and is a member of the IMA. Artemis Fund Managers Limited is a member of the Artemis Marketing Group. We only market our own unit trusts.

