We have a lot of sympathy with the view that the role of regulatory capital as a key measure of risk should be questioned and wonder whether the focus on regulatory capital has itself contributed to the crisis.

Our views remain that stress testing and scenario modelling are of paramount importance to an institution and should lead to action from the Board of the firm.

In 2009 we are expecting to see increased focus on liquidity risk management particularly in the light of the Basel paper issued in November 2008. Since this is likely to be to the detriment of other risk management within institutions, the next crisis will be from a different source. We believe that this will be credit risk where firms utilising the standardised approach in countries where general provisions are not permitted will have insufficient capital to deal with the losses that will actually occur. This is due to the standardised credit risk calibration being based on a QIS undertaken by the BIS in a benign credit environment. We would anticipate that all institutions on the standardised approach would now calculate a lower capital requirement that the equivalent bank using the IRB.

We are also expecting to see a greater focus on enterprise risk management due to the requirement for institutions to understand the totality of their risk environment on a consistent basis. This will involve better and more consistent modelling of risk appetite used as a driver of the risk programme within a firm, linked into stress testing, scenario modelling and economic capital modelling.

The Risk Reward 2009 Predictions

It must be emphasised that these are our views on the next 12 months. These are not in any way a forecast that should be used for trading purposes and we always recommend that you should take independent advice prior to making any investment decisions. We do not accept any responsibility for the accuracy of the materials contained in this section. However, many of you will know that we have been quite successful in previous years in reading the market. Together we will see how we do this year.

The real question is are we going to have a downturn or a crash?

Interest Rates

Whilst the short term pressures from what we see as being incorrect government intervention will drive interest rates downward, perhaps to 1%, this is unsustainable. Our expectation is that by the end of the first quarter of 2009 interest rates will have started to rise. We anticipate this to continue throughout 2009 and are extremely concerned at a potential spike in rates during 2010. As at 31 December 2009 we anticipate base rates in the UK being at 4.5% and are concerned that they could double in the following year.

US Dollar Exchange Rates

The unprecedented and unfunded US deficit continues to grow with a series of promises being issued which the US government in our view will be unable to finance long term. This is a serious source of concern and will represent a continual pressure on the US dollar. We see continual weakness against a basket of international currencies including depreciation over the year of around 15%. However there will not be a major change in the exchange rate against sterling as discussed below.

Sterling Exchange Rates

The UK government borrowing is also at a unsustainable level and needs to be taken under control as a matter of urgency. We cannot see any reason for sterling to strengthen against a basket of international currencies and expect a further 20% depreciation. In terms of the dollar the rates will remain at roughly current levels due to the combined weakness of both currencies.

The Oil Price

Last year we forecast that oil would fall within what we still consider to be its natural price band of $40-$60. We can see no reason to change this expectation and therefore continue to believe that the oil price will continually strive to stay within this band. In the short term the removal of the consumption pressures from both the USA and also China/India is having a significant impact and will result in the oil price continually stressing the bottom of the range. At 31 December 2009 a price of around $30 - $40 is to be expected.

Property Prices

Property is falling throughout much of the world. Whether you are considering commercial property in Dubai or residential property in the UK there is nothing that we can see that should cause property prices to rise. The development of infrastructural investments increases the costs of building and the lowering expectations of both companies and people will continue to cause problems for property. Our expectations are a reduction in UK property of 10%-15% and for UK commercial property of 20%-30%. In the case of retail space the fall will be higher – perhaps 35%.

In the US falls will continue, but we expect the largest falls globally to be in Dubai where a 40% fall in commercial property due to the absence of demand is to be expected.
The 2009 Risk Reward Predictions (Continued from page 3)

Stock Markets

Again there is no reason for much optimism. The lack of trust that is compounded by recent public failures will continue to represent a drag on the markets for the foreseeable future. We do not expect a significant rebound during 2009 with markets rising by perhaps only 5% over the entire year.

Bond Markets

The place where you will not want to be in 2009 is in our opinion fixed rate securities. Since interest rates are approaching their bottom you can expect to see fixed rate securities starting to fall. During 2009 a fall in value of perhaps 20% is to be expected on a global basis.

Commodities

As you will have noted we are not very optimistic about assets in general. Some of the brighter spots will be in physical commodities, particularly foodstuffs, which will retain current prices and could experience a small level of growth. Not spectacular but at least they may represent a safe haven in times of stress.

Ponzi Schemes

In the light of current news Ponzi schemes are back in the news.

The question you may be wondering is what actually a Ponzi scheme is and who was Charles Ponzi?

A Ponzi scheme is a technique used by fraudsters where the operator of the scheme promises high return to investors in short-periods but makes no actual investments at all. Instead, the operator will use money from future investors to show previous investors that a profit has been made, paying out sums that actually have not been earned. The scheme is completely reliant upon money coming in from new investors to continue to pay out the returns to existing investors. Effectively the investors who withdraw their funds are actually defrauding the new investors. If the flow of money from new investors ceases, so does that Ponzi scheme.

The scheme is named after Charles Ponzi who in 1919 conducted a scheme involving the buying and selling of international mail coupons. He promised investors a forty percent return in just ninety days. The prospect of high returns within a relatively short period of time is all a part of the attraction that comes with Ponzi schemes. Ponzi was able to take in $1 million within just a three-hour period in Q4 2008 Risk Update.

Finally always remember that if something looks too good to be true then it normally is too good to be true!