Investment Strategy in the Current Environment

The extreme volatility combined with the dramatic value declines in the vast majority of asset classes over the past 12 months has stunned even seasoned investors. Further, the (originally) disjointed and separatist pronouncements by Governments and regulatory authorities following the collapse of the financial markets only increased uncertainty and has led to a concerted drive towards both cash and the most secure of investments, notably US Treasury Bills and gold.

The investment community is beginning to emerge (although very battered and bruised) from out of the glare of the headlights to plan the path ahead. But what path and to where are we heading? If nothing else, the market correction has acted as a catalyst and in many cases has stimulated investors to adopt a "clean sheet approach" to formulate a plan for going forward.

A comprehensive investment strategy covers a multitude of areas including for example, asset selection and allocation, timing, investment risk, capital risk, currency risk, liquidity risk and (in many instances) reputational risk. These areas on their own can be complex and contain sub-areas that could be the subject of lengthy articles on their own. However, the aim of this article is to stimulate some lateral thought on a clean sheet basis to indicate how one can refine a search down to select targeted investment areas.

Where to Start?

But first, how can one describe an investment? In our experience the rationale behind the purchase of investment assets can broadly fall into one of two categories– (I) those assets that are purchased on the belief that they can be sold in the future to someone else at a higher price; or (ii) those assets that it is believed will accrete in value over time (through capital appreciation and/or income). Obviously many assets fit into either or both categories – but it is the investor's rationale (or attitude) behind the purchase that is the segregator, not the asset itself.

Some investors pay great attention to the economic cycle and select and rotate their investments depending on their views of the current position within a cycle and its length and strength. For example cyclical stocks such as steel manufacturers and steel stock holders are the classic early cycle out-performers, but are relatively unattractive later on as the cycle develops.

Another early cyclical play is the general retail sector and, as an example, look at the graph below of the Marks & Spencer PLC share price. For many market participants it may come as a surprise that the current share price is actually above the level of July last year - i.e. before the dramatic collapse in investor sentiment following the failure of Lehmans. Further, despite the company recently announcing a fall in sales of over 4%, the shares have risen by more than 50% from their lows in November – a classic example of the markets looking through the worst of the downturn and anticipating the economic recovery after a recession.

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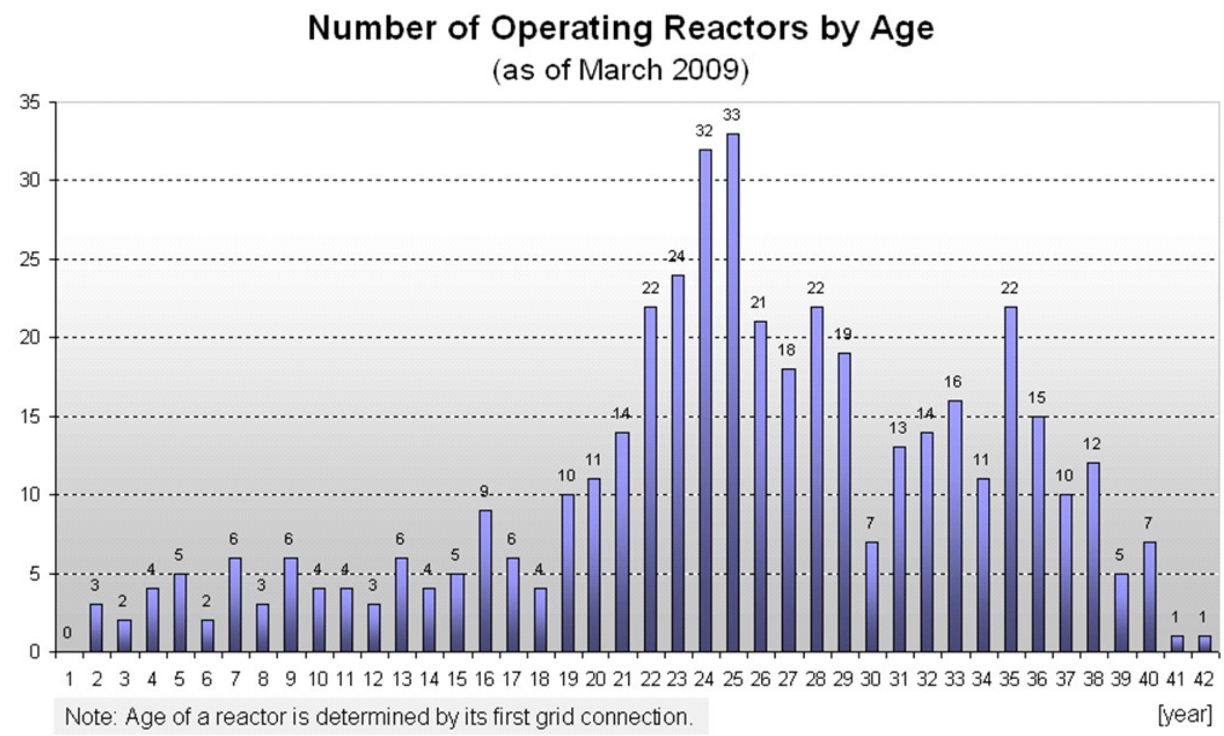
However, in this article, rather than engage in the merits or otherwise of sector and specific stock selection, we shall explore briefly some thought processes behind a few long-term investments ideas. We will leave the related questions such as asset allocation and risk mitigation to later articles.

Fundamental Research

Fundamental top-down research can identify major discernable trends that can indicate areas where investors can concentrate their efforts to uncover attractive investment opportunities. The following are three discrete examples selected specifically to demonstrate the breadth that free thinking can lead to.

Nuclear Power & Thorium

Since the Chernobyl incident in 1986, the paucity of commissioning new power stations has led to a sharp slow-down and virtual stagnation of global nuclear power generation. There were 340 nuclear power stations in operation in 1987, which grew to 438 in 2002 as plants under construction came on line (with Japan, S. Korea, India, China, France accounting for 62 of these) and currently number 436. Of these, 339 are over 20 years old with 127 of these over 30 years old – which is very significant considering the 40 year standard operating license period.



Source: International Atomic Energy Agency

With world electricity demand forecast to double by the early 2030s - and by which time all bar 72 of the existing nuclear power stations will have passed their 40th anniversary – nuclear power alone has the ability to satisfy this demand without the negative impact of carbon emissions. This process has already commenced with the number of power plants under construction rising from 33 in May 2008 to 44 today. Further evidence of growth comes from India which plans to increase the number of its nuclear plants by a factor of 4 times by 2020 and China by 10 times within the same period.

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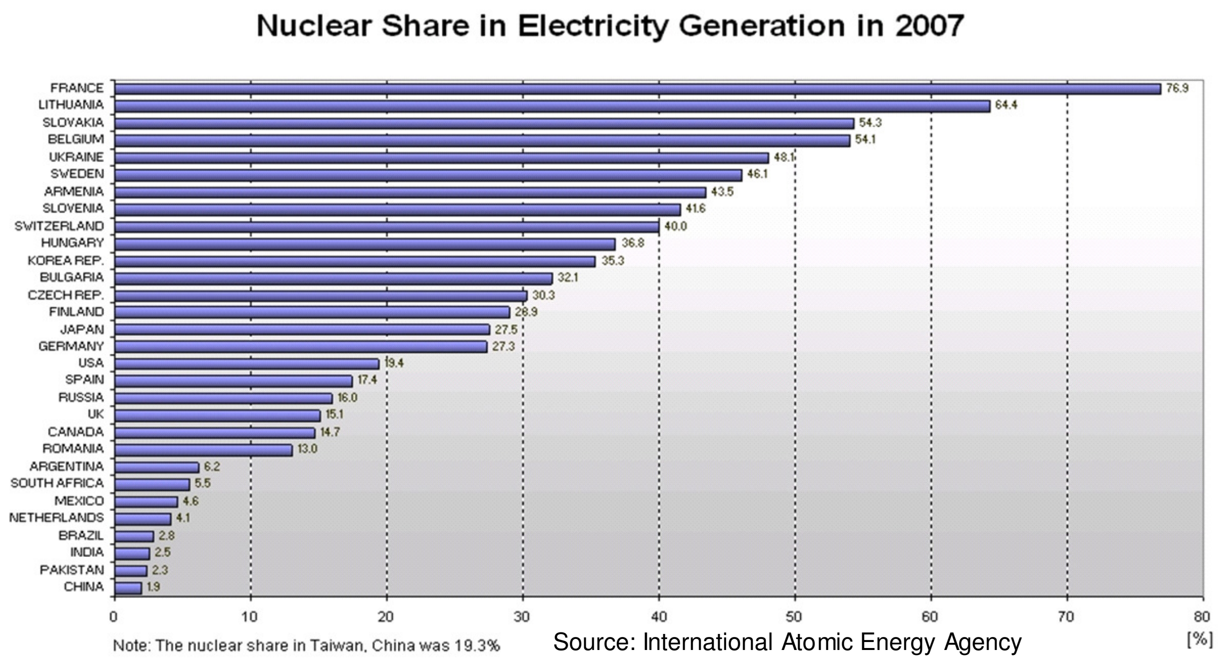

Source: International Atomic Energy Agency

There are a number of ways investors may benefit from this explosive growth. These could include investing in the companies that specialise in nuclear power plant construction and operation. Examples of such companies include Westinghouse in the United States and both EGF and Areva in France. Of course it is for the investor or their advisors to undertake the necessary investigation. Another area might be the companies that mine and process the necessary fuel required by such nuclear plants. These would again include Areva in France, but also companies like Cameco and other specialist miners, such as Extract Resources. A final potential market would be investing in organisations involved in plant decommissioning and the treatment and storage of the waste. Here apart from Areva, another company worth considering might be BNFL Plc.

Fuel Development

One of the biggest problems with nuclear power plants is that the waste fuel and its reprocessed by-products (notably plutonium) can supply the material for nuclear weapons. It was by using the waste from a Canadian-built reactor that India in 1974 was able to detonate a nuclear bomb. There is a need therefore for a new type of fuel to be developed for the nuclear industry which does not produce any such by-products.

Thorium Power, a company supported by the US Department of Energy has been working in Moscow since the mid 1990s employing former Soviet scientists and is researching and testing the use of Thorium as a replacement for uranium as well as developing the ability to retro-fit existing power plants to use the new fuel.

Thorium appears to offer the opportunity of a ⅔ increase in yield and a 70% drop in the overall production of waste and more importantly an 85% fall in the amount of plutonium (not a gram of which could be used for nefarious purposes). Of course, it has to work….

With the largest known deposits located in Australia, North America, Turkey and India, an investment in a Thorium mining company could prove spectacularly profitable should the metal deliver on some or all of its promises.

China

The International Monetary Fund forecast in March this year that it expects GDP growth in China to be in excess of 6% during 2009. This continues the strong growth achieved since China began its move towards a market-based economy in 1978. Over this period of time its economy has grown by a factor of over 70 times with most commentators concentrating their reviews on the manufacturing cost advantages during this period and the resultant growth in exports to the developed world. However, with the strength of the Remnimbi over the past few years and the recent collapse in world trade, this area has suffered drastically.

In our view, China still appears to offer extraordinary investment opportunities – but investors should concentrate on those entities that benefit solely from growth in the domestic economy, rather than dependence on international trade. With a growing domestic economy, the usual sectors should perform well (retail, consumer products and personal banking/credit). An area that has strong growth fundamentals is the delivery of fuel for transportation, including both petrol stations and LNG stations. There is also a rapid growth expected in the use of alternative fuels for taxis, local authority and government vehicles - China Natural Gas has exposure to this area. The recently announced huge Government stimulus through capital and infrastructure spend

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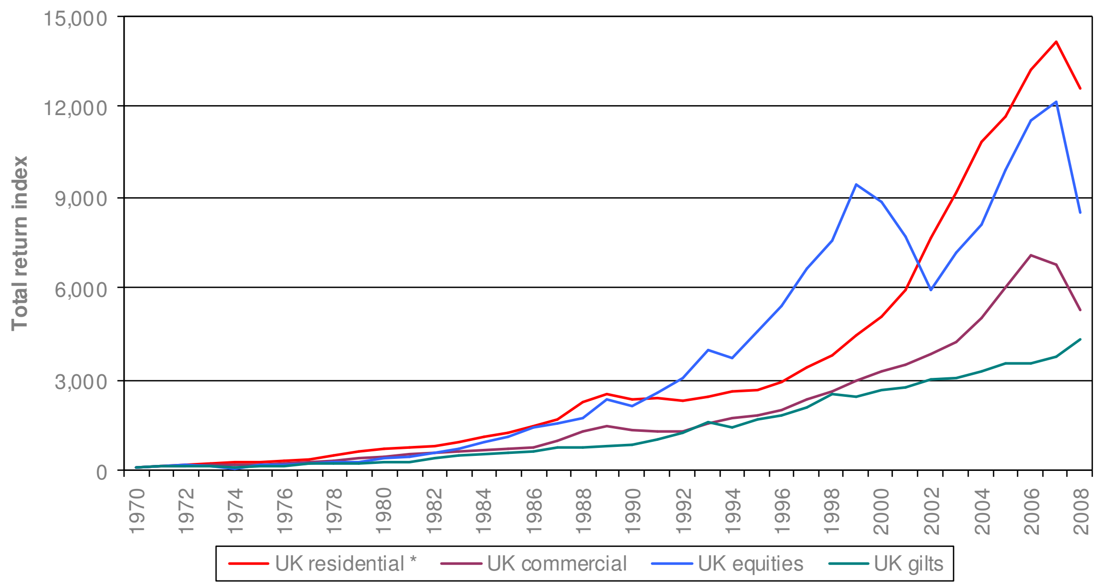
Investors could look further away from the norm to identify areas of future grow that appear relatively undiscovered. Demographics are a very useful investor tool and China is no exception in this. The IMF forecast that China will experience the highest percentage growth in the proportion of the population over 65 in the G20 countries between now and 2040, by a factor of over 3.5 times. This fact, combined with the growth in the wealth of the country would seem to indicate a strong rise in the requirements for the provision of healthcare and related services and products. The fact that the ratio of male births to female births is currently a very high 1.2 in China (versus 1.05 for the world as a whole), would also indicate that investment in the provision of healthcare services in China could be refined further still.

UK Residential Property

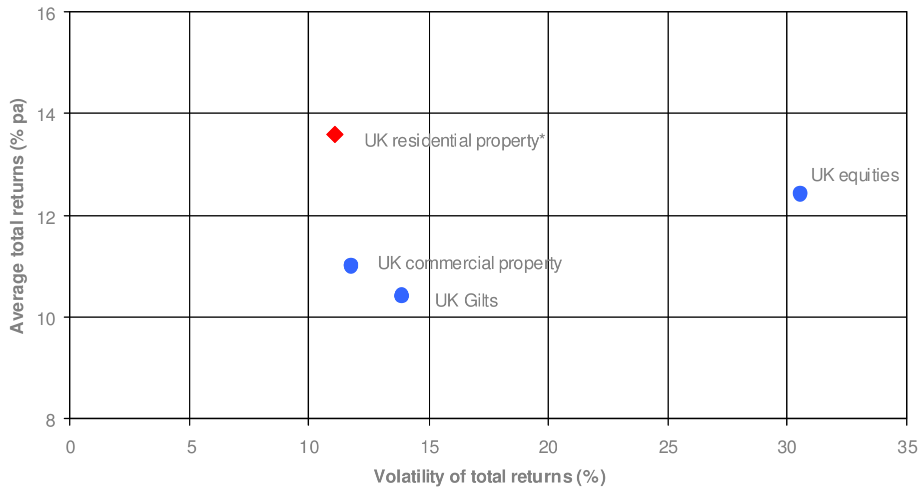
UK residential property has historically been an outperforming asset class for investors (see the graphs below).

Total returns of UK asset classes 1970-2008



* long run returns for residential property do not exist but are calculated as Nationwide house price growth per annum plus a 4% net

Risk and returns of UK asset classes 1970-2008



* long term returns for residential property do not exist but are calculated as Nationwide house price growth per annum plus a 4%

Source : Property Investigations, Nationwide, IPD

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The current demand and supply fundamentals of the UK housing market are in significant disequilibrium, with a housing shortage that has been estimated to equate to between 7 and 10 years of supply (Source: Joseph Rowntree Foundation, Barker Report, NHBC). Projections of the number of households for England & Wales, and London and the South East in particular, indicate that demand for all types of residential property is expected to increase rapidly over the next 20 years. There is no sign that the house building industry will be able to keep pace with these expectations even with the Government's proposed house-building programme in the South East.

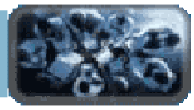
'With a high single figure net yield, investors can afford to be patient in awaiting future capital appreciation.'

Certain commentators expect that the fall in UK house prices will emulate, or even surpass, the decline in US house prices. However, the characteristics of both the demand and supply profiles for the two markets are very different. Various studies have calculated that the price elasticity of supply for the US market is high (above 1) and is generally between 2 and 4 (meaning that a 10% rise in house prices will lead to between a 20% and 40% increase in the supply of houses) and could be as high as 20. In contrast, Kate Barker in her Interim Review, stated that the UK housing market has "a low elasticity of supply in response to price changes" (i.e. a 10% increase in house prices will lead to less than a 10% increase in the supply of houses). Further her report stated that not only do "UK households have a high income elasticity of housing demand, but a low price elasticity of demand". This means (i) that as household income rises, the demand for housing rises faster; and (ii) that as house prices rise, demand for housing will not decline in proportion, but much more slowly.

Currently, it is possible to acquire portfolios that yield up to 10% on cost located in and around London that address the market segments with the greatest projected excess of demand over supply. Investing in straightforward physical bricks and mortar provides its own comfort and risk mitigation as compared to derivative and leveraged investment products. With a high single figure net yield, investors can afford to be patient in awaiting future capital appreciation.

In conclusion, the recent market turmoil will, if nothing else, force investors to examine more closely the methods and rationale behind their selection of investment assets and /or investment managers. History indicates that if an improvement is sought, then one's methods and constraints should change – or at least be examined afresh. It would be contrary to reason to expect things to change whilst doing nothing differently.

Co-Sourcing or the New Way to Ensure Audit Excellence



Have we really been through a Risk Management Revolution?

'There is no question that a risk management revolution has indeed happened and life in a bank, as we know it will never be the same again.'

Well, they're not our words. In fact they come from the South African Reserve Bank's guidance on the Internal Capital Adequacy Assessment Process (ICAAP) which was a key document in a consulting assignment we recently completed for a South African client. So we thought it would be helpful if we spent some time pondering on this so-called revolution. Has one really taken place and, if it has, what are the implications for internal auditors?

There is no question that a risk management revolution has indeed happened and life in a bank, as we knew it, will never be the same again. The events that led up to the revolution are spread over more than a decade and are well documented. They include the deregulation and globalisation of financial markets, business consolidations through mergers and acquisitions and greater concentrations of processing power in fewer locations enabled by the rapid pace of technological innovation. Most important, perhaps, is the emergence of risk intermediation and the proliferation of securitisations and derivative transactions and an ever increasing complexity of deal structures.

The truth is that this advancing sophistication of financial products and the markets where they are traded have combined with technological innovation to produce a new reality. Banks must now come to terms with the fact that when trades and transactions enter their operating environments they trigger risk exposures that can go well beyond nominal transaction values.

The current financial crisis can be linked to accumulating risk exposures which, in a number of well publicized cases, escalated to $ billions without always finding expression in the affected banks' financial accounting and risk reporting systems.

The Société Générale fraud and sub-prime failures are such examples. What is also evident is that such unidentified and unmeasured accumulations of risk were not attributable to any particular category of risk but a rather potent cocktail of all of them… credit, market, liquidity and operational.

These events served to heighten the awareness of banks and regulators to the need for the ongoing identification, measurement and management risks across the enterprise. The global regulatory response was Basel II complemented by a requirement from most national regulators that banks confirm, in their Internal Capital Adequacy Assessment Process (ICAAP), that all risks have been identified and measured, are subject to appropriate management and are covered by sufficient capital reserves. There is also a direct impact on internal auditors as every regulatory authority around the world that we are aware of requires that the ICAAP be subject to regular internal audit.

But if the evidence suggests that conventional financial and risk management systems are simply not capturing and reporting all of a bank's exposures to risk, what chance does internal audit stand of identifying unreported and / or improperly measured risks during the course of their audits? The answer is quite a good one provided the audit plan is suitably risk-based and the audit team has the necessary skills and preparation. This may be easier said than done. There are two ways Risk Reward can help: