

# Discretionary Management Service

## Investment Bulletin – January 2011

20th January 2011

### Market Report



As we begin the New Year, financial market conditions continue to challenge even the most experienced of investors. The corporate picture has improved markedly in the past year: the economic environment in indebted developed nations, whilst better than it was, still faces many challenges ahead. Event risks concerning European nations such as Ireland continue to have short term negative and volatile effects upon global markets, with many of the problems associated with these nations far from being resolved.

Ignoring volatility briefly, equity markets in major centres such as New York and London have performed well over the last year (albeit appreciating over 7% in the last five weeks of the year). Areas of these markets exposed to sectors such as raw materials, energy and commodities have been the major drivers of capital appreciation here.

From the perspective of the UK domiciled investor, exposure to the drivers highlighted above have been positive for portfolios. When considering the store of wealth, these factors also pose structural economic problems going forward, problems which will impact upon all client portfolios from Ultra Conservative to High Risk investors.

Using copper as an example, factors such as the remote geographical regions in which large deposits of this commodity are found, the lack of skilled labour needed to extract this basic material and the increasing demand for the metal from growing emerging nations such as China, have helped contribute to the record high prices we are currently experiencing in the best conductor of electricity.

The majority of these imported structural problems are likely to persist, with UK consumers and investors alike faced with a low growth economic environment. This is largely characterised by increasing inflation and benign wage growth. Retail price inflation (RPI), including inputs such as food, energy and housing costs, remains at a stubbornly high annual rate of 4.6%, while consumer price inflation (CPI) – excluding housing costs - currently stands at 3.3%, 1.3% over the Bank of England's inflation target of 2%.

Putting this into the context of client portfolios, in order to maintain a positive store of wealth or purchasing power, investments made within client portfolios going forward will have to produce a total return (income and capital growth) equal to or in excess of inflation, through capital growth, inflation protection, or a mixture of both components.

Domestically, the opportunities to achieve this investment goal have diminished considerably over the past eighteen months. Not only does this force us to seek greater exposure to global investment assets (due to enhanced growth prospects internationally), a greater number of asset classes, such as Gold, will have to be utilised with client portfolios in order to achieve this goal.

Having conducted our annual bench-test of client portfolios, the increase in geographic exposure is not without risk, indeed a wider range of annual expected portfolio returns can now be expected going forward. However, this action is necessary in order to avoid an erosion of capital (purchasing power) in all portfolios resulting from cost push inflation.



### **MPL Asset Allocation**

#### *Cash*

Fixed term deposit rates will continue to remain at low levels, until the loose monetary stance currently being adopted by the Bank of England is changed. This could now potentially begin to happen within the next year due to concerns over the structural inflationary pressures mentioned above. However, the Monetary Policy Committee will have to strike a fine balance between the containment of these pressures and the potential of making a monetary policy mistake that could derail the economic recovery by putting the besieged UK consumer under further financial strain.

#### *Fixed Income*

##### UK Treasury Gilt Market

Index linked gilt holdings have risen in recent weeks as the UK retail price index (RPI) continues to increase following rises in food, energy and commodities prices. The Value Added Tax (VAT) increase to 20% may also have a short term inflationary impact over the next 6 months, similar to that of the inflationary effects experienced last January following the VAT increase from fifteen to seventeen and a half percent.

Whilst our UK Treasury market holdings are protected against inflation, holdings here will be trimmed ahead of the potentially negative effects of a tightening in UK monetary policy by the Bank of England.

##### Emerging Market Debt

The structural story regarding Emerging Market Local Currency debt (and indeed equities) remains intact at the start of 2011.

According to International Monetary Fund (IMF) estimates, the global cyclical rebound in economic growth will continue. Real growth in global Gross Domestic Product (GDP) of 4.2% is forecast, driven by developing nations where growth of 6.2% is expected. These estimates compare to forecasts of a moderate growth in developed nations' GDP of 2.2%, with these nations continuing to struggle with substantial debt positions.

Untrammelled by the structural debt concerns currently experienced in developed nations, emerging nations will in the longer-term continue to benefit from improvements in creditworthiness (which will decrease lending rates leading to further capital gain on bond holdings for existing holders). Demographic factors, such as a burgeoning middle class who will require a greater level of life and pension planning, will also be supportive. This translates into a greater level of demand for emerging market bonds from local pension and insurance companies who have to match their clients' longer term liabilities. This level of increased demand will again lead to capital gain in the longer term for holders of emerging market debt.

##### UK Corporate Bond Market

Investment grade corporate bond issuers, particularly in the Mining and Industrial sectors, continue to perform well - reporting improved earnings and cash flows. In the longer term, this continued prosperity should hopefully lead to credit rating agency upgrades for these corporates over the course of the business cycle.



### *Equity*

At the beginning of 2010 European event risks were significantly affecting the global financial stage. Our thoughts were very much focused upon access to regions with minimal exposure to these risks. The aim here was to gain access to these areas through Western organisations, not only to avoid these event risks, but to benefit from the continued growth here. In the course of the last year we also began to gain direct exposure to these areas, as they will hopefully continue to help drive portfolio values forward, resulting from some of the structural examples given earlier in this letter.

Unfortunately the consumer in many indebted developed nations such as the United Kingdom now faces a two tier global economy. The lower tier continues to face factors such as lower economic growth prospects, higher ('cost push', i.e. increasing prices of productive inputs) inflation, minimal wage growth and, in the short term, the prospect of monetary policy tightening (increased interest rates), which will place these consumers under further financial pressure.

The upper tier benefits from factors such as excellent economic growth prospects, good employment growth (which has also led to inflationary pressures, due to skills shortages creating enhanced wage growth, which in turn has led to increased inflation through higher wages in addition to cost push inflation), and most importantly, changing demographics (from the fields to the factories) which is creating greater demand for basic consumer products and services. This factor is now the ultimate driver of global economic growth at present and will continue to influence the increasingly globally focused nature of our client portfolios.

### *New member of our team*

May we take this opportunity to welcome Simon Weighell to the MPL Investment Department. Simon is a Senior Investment Manager with over twenty years of experience and will help us in the continued development of the investment management proposition for our advisory clients, as well as assisting the investment management team in the operation of our Discretionary Management Service.

May we wish you a happy and (hopefully) prosperous New Year whilst thanking you for your continued support for MPL Wealth Management.

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