

May 2010

A Greek tragedy

Equity market performance diverged sharply in April as strong economic news from the US collided with a rapid deterioration in the Greek debt situation and continued concerns over China. With UK investor focus firmly on the 6 May general election equities lost ground on profit taking, particularly in the dominant oil and mining sectors.

It was inevitable that at some point early in its life the euro would face a serious challenge. This month it came as Greece officially sought help from the International Monetary Fund and the other European countries and as bond rating agency Standard & Poor's downgraded Greek government bonds to "junk". Less severe downgrades to Portuguese and Spanish government debt simply added to fears of contagion and led to sharply higher bond yields in countries at risk. While the knock on effect is to increase interest payments, the weakness of the Euro should more than offset this across the Eurozone.

UK equities gave up 2.2% as equity investors took risk off the table. Manufacturers and technology stocks continued to rally on the back of excellent results from their US counterparts and as domestic news picked up further. April's Purchasing Manager's Index reflected increasing strength in all components and the first positive reading for employment intentions in a long time.

Top performers included uninterruptible power supply manufacturer **Chloride**, up 40.5% on a bid from US manufacturer **Emerson** and private equity fund **Candover** up 31.5% on news that the Alberta Investment Management Corporation was considering a bid. We also saw major moves in the smaller more economically sensitive support service companies such as motor dealer **Inchcape** up 15.9% and van rental business **Northgate** up 16.3%. Strong gains in B&Q owner **Kingfisher** up 15.3% and concrete paving manufacturer **Marshalls** up 15.8% suggest that the building trade is seeing a pick up.

On the downside **BP** gave up 8.8% on news of an explosion and loss of a deep water oil production rig in the Gulf of Mexico and concern over the cost of cleaning up the resulting oil spill.

Performance - 12 months

Index	Level	Change
FTSE 100	5,553	30.9%
S&P 500 (\$)	1,187	36.0%
MSCI Europe ex UK (Eur)	97.5	26.5%
MSCI Emerging Markets (\$)	1,020	53.9%
Nikkei 225 (Y)	11,057	25.3%
FTSE Private Investor Balanced	2,854	22.2%
Gold (\$)	1,167.1	30.5%
Oil (\$)	87.4	39.4%

Source: Bloomberg; Fidessa

The volatile miners also fell with Xstrata, down 16.4%, typical of the sector which was hit hard by investors' reduction in risk appetite and as miners factored in the prospect of higher taxes proposed by Australia.

First quarter results continued to beat expectations, managements presented positive outlooks and economic statistics improved further

The US S&P500 rose 1.5% as first quarter results continued to beat expectations, as managements presented positive outlooks and as economic statistics improved further. Sales of new homes surged 27% in March helped by a government tax credit and better weather while durable goods orders rose 2.8%. Sales of **Apple's** latest hot product, the iPad, got off to a very strong start, demonstrating consumer's continued propensity to spend on technology despite harder times and driving other tech stocks higher.

European equities lost 2.2% with French, Dutch and Italian banks hit particularly hard on balance sheet exposure to Greek and other government bonds now perceived as higher risk. Underlying economic news continued to improve with strong increases in manufacturing output among others, something the weaker Euro will continue to fuel.

Although Asia and emerging markets were largely positive China continues to be a concern with the China (Shanghai B) index falling 4.4% in US dollars. China continues to tighten monetary policy, raising the amount of money banks must hold with the central bank again during the month to rein in excess speculation. Driven by commodity exports, strength in the Australian economy led the Reserve Bank of Australia to tighten again, raising interest rates by 0.25% to 4.5%, the sixth rise since the crisis ended.

The Euro was weaker against all major currencies as investors were forced to reassess their view of its status as a sound reserve currency. In fact a weaker Euro is not entirely unexpected at this point of the economic cycle when a growing US economy is attracting capital. In the long term a weaker Euro will stimulate growth, however the crisis is not going to go away quickly and the risk of the contagion spreading to Spain, Portugal and eventually the UK remains high.

In the short term sterling has been a beneficiary, with gilt yields falling to 3.9% from over 4%. However if the incoming government fails to satisfy investors' expectations that the deficit will be addressed then we could be in for a very difficult time a few months down the line. While we continue to find specific stocks that are of interest we generally prefer cash generative companies with strong balance sheets and international earnings.

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Risk is suddenly back on the agenda

Economy

Economic news continued to surprise on the upside around the world with the exception of China, causing many observers to raise their estimates for growth.

In the US increasing strength was reflected in rising new home sales, in higher durable goods orders and an excellent first quarter earnings announcement season. There is evidence that investment is taking over from inventory building as the driver of growth.

For most economists the main event has been Greece, a crisis that strikes right at the heart of the European project. A decade ago membership of the euro held out the promise of lower interest rates, currency stability and faster economic growth in return for greater financial discipline. In fact, maintaining that financial discipline has proved impossible for the peripheral countries that have used low interest rates to fuel property booms and consumption rather than investment. Now, faced

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with a loss in competitiveness and unable to devalue their currency, painful internal adjustment is the only mechanism open to them.

The Irish have undertaken this already with measures that included cutting civil service pay by 5% to 15%, tax hikes, and public sector spending cuts. Proposed austerity measures for Greece include raising the retirement age to 67 from an average of just 53 and a rise in VAT to 23%. Combining this with a €110 billion rescue package to allow Greece to refinance for three years without going to the markets sounds impressive. Investors worried it would not be enough.

The social and political dimensions of currency union that were widely ignored when establishing the Euro are now centre stage as Germans and other good Europeans eventually found

Global economic growth and inflation forecasts (%)

2009	2010e	2011e		2009	2010e	2011e
-5.0	1.2	2.0	UK	2.2	3.2	2.2
-2.4	3.5	2.9	USA	-0.3	1.8	1.8
-5.0	1.1	1.4	Japan	-1.4	-0.8	-0.4
-4.0	0.9	1.1	Euro Zone	0.3	1.1	0.8
-7.4	3.5	2.8	Eastern Europe	7.5	6.1	6.1
BRICs						
-0.1	5.5	5.0	Brazil	4.3	4.9	4.8
-9.0	5.5	2.5	Russia	9.2	8.0	8.0
5.7	8.5	9.0	India	10.9	8.0	6.0
8.5	10.0	9.0	China	-1.4	3.8	5.3
5.4	8.2	7.8	Asia ex Japan	2.2	4.6	5.2
-2.1	3.0	3.0	World	1.4	2.4	2.6

Source: SG Securities

themselves providing the lion's share of an EU and International Monetary Fund stabilisation package expanded to a staggering €750bn. Being a good European comes at a cost.

Strategy

Our positive view on equities last month was undone in the short term by a sharp increase in risk aversion on the Greek situation and slowing growth in China and Latin America. In all recoveries there comes a point where investors who are over-exposed to the cyclical recovery stocks must reduce their positions and weakness in mining and bank stocks in particular suggests this is underway.

Our longer term collective view remains that the sharp V-shaped economic recovery was already factored into prices but that the general outlook for equities remained positive as corporate investment and employment picked up.

At a glance

Negative	Neutral	Positive
Sterling Cash	International Bonds	UK Equity
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	Hedge Funds	Inflation Linked Bonds

In the short term markets are volatile and we see this shake out as an opportunity to pick up stocks we like at lower prices. US dollar denominated assets and gold should benefit most from the uncertainty but our longer term views are unchanged.

Themes

We are keen to use recent falls to invest in some of the specific themes we have been following. We have already mentioned that we generally prefer cash generative companies with strong balance sheets and international earnings, largely because the government is going to have to take radical steps to deal with the deficit. If successful the UK economy will stagnate at best and if unsuccessful the currency will fall.

European stocks that have caught some investment managers' attention include Swiss pharmaceutical company **Roche** and **Nestle**, the world's biggest food manufacturer. We also saw buyers of oil majors **Total** and **Statoil**, soap to food manufacturer **Unilever** and for some clients **BAT**. In North America we selectively added **Canadian Pacific Railways** and in the UK added to **HSBC**, and international can and bottle maker **Rexam**.

We also took part in a small way in the launch of Anthony Bolton's new fund, the **Fidelity China Special Situations Investment Trust** and the **JP Morgan Brazil Investment Trust**.

Market upsets do nothing to change our view that companies with dominant market positions and pricing power tend to be the long run winners. We have already mentioned **Roche** but closer to home would include internet insurer **Admiral Group** and food retailer **Tesco**.

Another theme that consistently delivers is corporate restructuring. Undervalued situations where some managers continue to run positions would include investment trust **China Real Estate Opportunities** pending its move from an AIM listing to Singapore and **West China Cement** which is moving its listing to Hong Kong.

The Savoy Zero Service

Many investors are attracted by the promise of predictable growth and returns. This can be achieved in a number of ways. The traditional approach was to bias portfolios towards fixed interest and higher yielding blue chip equities on the basis that this lowers volatility. But much of the return is received as income and not everybody wants income, particularly if it is going to be taxed at 40% or more.

How the Savoy Zeros Service can help

Most investors are familiar with ordinary shares but these are just one type of security a company can issue. Another less well known type is the Zero Dividend Preference Share, or Zero as it is more commonly known. Zeros are simply another way that a company can borrow money and are attractive to investors who prefer capital gain to income.

The service also identifies structured products that have similar attractive characteristics.

How Zeros work

Rather than borrow 100p and pay 7% interest for five years a company could decide to issue a Zero at 100p and repay 150p after five years. This would give investors a compound annualised return of 7.0% but it would be received as capital gain.

Are they easy to buy and sell?

Zeros do not have to be bought at issue and there is a thriving secondary market. They are traded on the stock market in the same way as shares and are easy to deal in. However because

they are generally held for the long term Zeros do not trade as frequently as ordinary shares and the prices quoted by the market are sometimes not very competitive. Savoy has considerable expertise dealing in Zeros and frequently improves on price.

Can Zeros default?

Yes they can. Zeros are a form of corporate debt and repayment depends on the performance of the underlying business and the value of any assets on which the debt is secured. Our analysis pays particular attention to asset cover, where the Zero ranks in the issuer's debt structure and makes recommendations based on projected return and security.

Who issues Zeros?

The issuers are largely investment trust companies that invest the money raised alongside their ordinary share capital, in stocks and shares. Repayment of the Zero is expected to be a combination of the original loan plus the investment gains, with any shortfall coming from the company's ordinary share capital.

What about Structured Products?

Although they are issued by financial institutions rather than companies some are very similar to Zeros and offer similar benefits. Like Zeros the terms of each issue are unique and our research focuses on identifying those most suitable for private clients.

Income and savings

Deposit rates likely are to remain low for the foreseeable future so equity income remains one of the few ways to boost income, if you are able to tolerate some volatility in your capital. Investing in equities has a further advantage - many are multinationals and this is a way of removing some of your capital from the UK without feeling that you are taking a large currency bet.

Taxing times ahead for all

March's budget did little to help income seekers though it did

stop short of making the position even worse. For now the generous tax breaks on ISAs and personal pension plans including SIPPs remain favourable. For example the ISA allowance rose this year to £10,200 and is available to all over the age of 18 years. For now the rate of tax on capital gains is also unchanged, at 18%.

We think it prudent to make your annual contribution now and to review the timing of any pension contributions too.

Name	Price	Mcap £bn	FTSE %	PE Ratio				Yield %				Dividend Cover Y1e
				H	Y1e	Y2e	Y3e	H	Y1e	Y2e	Y3e	
AVIVA PLC	348.7	9.6	0.7	N/A	6.3	5.2	4.8	6.9	7.3	7.8	8.6	2.2
SCOTTISH & SOUTHERN ENERGY	1,085.0	10.0	0.7	27.8	10.2	10.0	9.4	6.2	6.5	6.8	7.3	1.5
BP PLC	575.5	108.1	7.6	8.2	8.2	7.1	6.5	6.4	6.5	6.8	7.0	1.9
NATIONAL GRID PLC	629.0	15.6	1.1	12.8	10.9	10.8	10.3	5.8	6.1	6.6	7.1	1.5
VODAFONE GROUP PLC	145.4	76.5	5.4	13.2	9.3	9.3	8.9	5.4	5.6	5.8	6.2	1.9
ROYAL DUTCH SHELL PLC-B SHS	1,975.0	125.8	3.8	12.7	10.1	8.2	7.4	5.6	5.6	5.8	6.0	1.8
ASTRAZENECA PLC	2,889.0	41.8	3.0	7.8	7.2	7.2	7.8	4.7	5.5	5.7	5.9	2.5
BRITISH AMERICAN TOBACCO PLC	2,054.0	41.0	2.9	16.7	11.9	11.0	10.0	4.1	5.5	5.9	6.5	1.5
BT GROUP PLC	126.7	9.8	0.7	-	8.7	8.0	7.8	2.7	5.4	5.9	6.6	2.1
GLAXOSMITHKLINE PLC	1,211.0	62.9	4.4	10.7	10.0	9.8	9.1	5.1	5.3	5.6	6.1	1.9
BAE SYSTEMS PLC	344.4	12.0	0.9	-	8.1	7.9	7.4	4.6	4.9	5.2	5.3	2.5
CENTRICA PLC	294.6	15.1	1.1	23.2	12.8	11.6	10.5	4.3	4.6	4.9	5.3	1.7
IMPERIAL TOBACCO GROUP PLC	1,867.0	19.0	1.3	12.6	10.5	9.6	8.8	4.1	4.5	5.1	5.6	2.1

Source: Bloomberg

Y1e = Next corporate year end

Roche Holdings AG

Attractive

Roche is the world leader in in-vitro diagnostics and drugs for cancer and transplantation. It is also active in other major therapeutic areas with a high medical need such as autoimmune diseases, inflammatory diseases, virology, metabolic disorders and diseases of the central nervous system. We view the shares as attractive compared to the traditional UK alternatives, Glaxo and AstraZeneca.

Sales in the US account for 40% of turnover, Europe for 37% and Japan for 10%. The Pharmaceuticals Division, 80% of sales, consists of Roche Pharmaceuticals along with Genentech and also Japan's Chugai in which the company has majority shareholdings. It focuses on innovative medicines primarily in the areas of Oncology, Autoimmunity, Metabolism, Virology and Central Nervous System.

Roche's leadership in biotech was reinforced with the March 2009 acquisition of Genentech which added blockbuster cancer biologics Avastin, Rituxan and Herceptin to the portfolio. Two thirds of Roche's pharma products are now biologics. These are not the usual chemically engineered compounds easily copied by generic manufacturers. Avastin for example, was first developed as a genetically

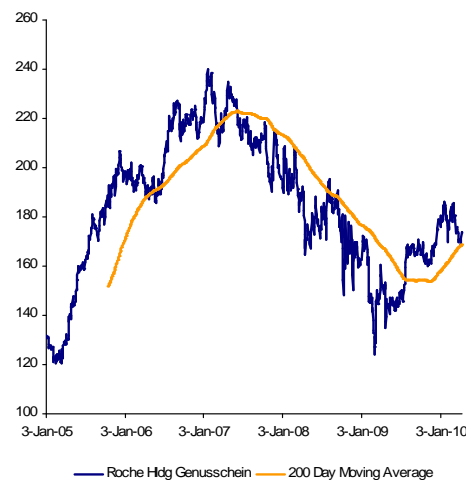
engineered version of a mouse antibody that contains both human and mouse components. The group has a strong pipeline of new drugs undergoing trials in the hepatitis C, diabetes and cancer markets with no patent expiries before 2015.

The Diagnostics Division, 20% of sales, provides products and services for in-vitro diagnostic testing, which includes reagents and instrumentation in the area of molecular biology, clinical chemistry, immunochemistry, haematology and coagulation.

The 2008 acquisition of Ventana brought fast growing tissue diagnostic technology to the group and Roche is number one globally in in-vitro diagnostics.

There are risks. Roche derives 35% or so of its total revenue from Avastin, Rituxan and Herceptin and its diabetes operation suffers intense competition in the US. Like all pharmaceutical companies it is vulnerable to cuts in government healthcare spending.

The stock is not expensive, with double digit earnings growth expected for the next few years and a yield of 4% We view Roche as attractive relative to the two traditional UK alternatives, Glaxo and AstraZeneca.



Source: Bloomberg; Savoy
Genuschein = Participation certificate

Price (CHF)	165.4	Ticker	ROG.VX		
Mkt Value (m)	143,419				
Dec	PTP m	EPS	Div	PER	Yield
2009A	12,277	9.1	6.0	18.2	3.6%
2010E	14,524	12.8	6.6	12.9	4.0%
2011E	16,522	14.3	7.5	11.6	4.5%

Performance (%) Absolute vs Swiss Market	
1 month	-1.6 5.1
3 months	-2.6 5.4
12 months	-14.9 -5.2

Source: Bloomberg; Fidessa

Recommendations

We rate investment strategies, themes and securities as either positive/attractive or negative/unattractive. This recognises that your attitude to risk, time horizon, financial position, tax position and tolerance for loss versus gain is unique. Your investment manager will only adopt those ideas that in their opinion are suitable for your portfolio and investment strategy at the time.

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