"I Forgot More Than You'll Ever Know (About Them/Her)"

Sir John Templeton on Stock Markets/Cecil Null on a Lost Lover

There is no need for us to enumerate the worries and uncertainties out there. We feel them as keenly as everyone else and can articulate as apocalyptic a bear case as the next man. But we also recall and acknowledge the force of a piece of wisdom shared by Sir John Templeton – one of the great investment practitioners of the Twentieth Century - at a seminar over 20 years ago. He said, and I paraphrase, "The best time to buy sound common stocks is when economic conditions are most uncertain." A cursory glance at almost any long term stock market index demonstrates this to be good advice (although Japan is beginning to test one's patience) and it is worth reiterating why.

First, the headline on the front page of one of this month's white Times read – "Oil at $100 threatens to choke the economy". Bad news is quickly incorporated into share prices and what everyone knows ceases to be useful knowledge. In the UK, economically-sensitive stocks have already been hammered. Selling more of these shares today is reactive, not pre-emptive, and risks aligning oneself with the community of short-selling momentum traders – and, over time, those fellows are notorious money-losers.

Next, when economic times are tough, interest rates tend to fall and are falling today – extending investors' time horizons beyond current difficulties and back to Capitalism's tendency to generate 7.0% pa real returns over time. And here Templeton's advice is subtle. To the extent that monetary authorities over-react to tough times they risk inflation and to that extent, common stocks – equity - become more attractive than cash or debt, because equity can protect against inflation. **Selling sound common stocks into a slowdown, in exchange for cash, is definitely a losing strategy.**

Moreover, so far as UK equity investors are concerned, it is important to recall that our economic slowdowns tend to be associated with weak Sterling. The composition of the London stock market means that a falling Pound translates quickly into rising dividends and, later, earnings upgrades. Sterling's recent break below $2.00 is very bullish.

Finally and perhaps most important, although it is beguiling to believe that stock market waves are neatly correlated with the ebbs and flows of economies – it is just not so. **Equities often perform well in recession years.** One reason for this is that the people who run corporations are less prone to skittishness than stock market participants. Boards will often look to transact deals into a downturn, because this is when holders are more prone to sell. It is no accident, we think, that BHP should have bid for RTZ well after the, at least temporary, peak of industrial metal prices, nor that Santander is expressing interest in Alliance & Leicester at a time of maximum distress for the latter's shareholders.

Listen to what Kenneth Lewis, CEO of Bank of America said earlier this month about his purchase of Countrywide Financial, the troubled US mortgage lender, at a price 84% below its peak. "Countrywide presents a rare opportunity for Bank of America…to affirm our position as the nation's premier lender to consumers…Home ownership is a fundamental pillar of the US economy and over time it will be a key area of growth for (us)." Countrywide originated $408 billion in mortgages in 2007, has a servicing portfolio of $1.5 trillion and 9 million loans – yet Bank of America is buying it, as one analyst put it, for "little more than a rounding error on its own balance sheet". Ken Lewis promised he wouldn't take action until "there was blood in the streets". Clearly, he was up to his elbows in gore by mid-January.

So, while it would be wrong to imply that we are complacent about the shocks of the last six months – we are not, and are taken aback by the punishment meted out to some of our holdings - nonetheless, we remain positive about the outlook for UK equities and guess there will be big positive surprises over the next 12 months. Those running heavy cash positions will need to be nimble or lucky.

The truth is that although macro-economics make compelling headlines, we do not invest in macro-economics. We invest in corporations and, for the most part, we invest in corporations that have weathered macro-economic storms in the past and come out stronger on the other side. Listen to what the companies are saying about themselves, not what the City traders are saying about their share prices and the outlook becomes less threatening, even encouraging!

So, looking into the New Year, we now offer observations, some more detailed than others, about the prospects for each holding in our core UK portfolio, starting with the smallest position.

Portfolio Analysis

Halma A specialist engineering/controls company with one of the most consistent records of high return on equity and cash generation that we know on the London stock market. The company is conservatively financed, with no net

debt and has a steady growth opportunity, driven by worldwide legislation requiring installation of safety controls at industrial and commercial sites. Nonetheless, closer than many of our holdings to our long term price target and we have reduced in recent months.

Hargreaves Lansdown Recent weakness has encouraged us to commence a holding in this private wealth savings franchise. Personal acquaintance gives us the highest regard for the business and its executives and we expect 2008 to be an active year for the UK savings market.

Celtic There has been a flurry of stake-building in the club, with John Fisher, son of the founder of GAP Clothing, a newly declared 3% shareholder (and in the process thwarting our attempts to buy more). Celtic is a mighty "trophy" asset, valued far more lowly in the stock market than comparable franchises.

Euromoney This business-to-business publisher is majority owned by Daily Mail. In December DMGT lifted its holding in the company from 61% to 66%. For us this decision confirms the undervaluation of Euromoney today and increases the likelihood that one day DMGT will acquire the minority. In the meantime, the shares yield more than a gilt.

Daily Mail An outstanding collection of newspaper and online brands, which is deeply out of favour, with a share price 60% below its 2000 peak. We are adding to a modest holding and give thanks that the stock market, in its passions, throws up opportunities like this – to own a piece of, say, the Daily Mail newspaper on 10x earnings or an earnings yield of 10%, because, temporarily, earnings are "under pressure".

Fullers, Marstons, Youngs All the pubcos are derating, as investors discount a slowdown in UK consumer spend and real estate cools. These three have been weak shares, as a result. Nonetheless, integrated regional brewing remains a reliable business model, generating real long term dividend growth for patient investors. The recent private equity bid for water utility Kelda reminds us that there are still buyers for the "utility-like" cash generation of pubs. Fullers and Youngs offer access to unmatchable London pub estates, while Marstons yields more than a gilt.

Bradford & Bingley Rumoured to be interested in all or part of Northern Rock, rumoured to be a merger partner for Alliance & Leicester, the B&B board appears to be doing the right thing – looking for value-creating opportunities in a period of investor uncertainty. The British banking industry is about to consolidate and B&B is not a negligible franchise. In the meantime the bank has the highest Tier 1 ratio of any of the UK banks, except for HSBC and no unsecured loans.

Royal Dutch Shell Life is tough for the oil majors, despite the rising crude price. Crucially, the black stuff is getting harder to find and more of the proceeds have to be shared with the host nations. Neither Shell nor BP are replacing reserves as quickly as they need. We believe their shares should offer a significant dividend yield premium to the stock market, to compensate for the risk and that Shell's current 7.5% premium is not enough to encourage us to do anything but hold the shares today. We have sold shares recently above £20.

Fidessa Shares have fallen 41% since mid-October. This is understandable, given that Merrill Lynch is a corporate shareholder (will it be a forced seller?) and its biggest customers are investment banks. Indeed, 85% of all tier-one global equity houses now rely on Fidessa's software to enable them to process still exploding volumes of share transactions. We believe investors underestimate the reliability of this entrenched market position and its strategic value.

Schroders A cash-rich, globally-recognised investment management franchise, with an inbuilt profit driver – the transition from low margin institutional business to higher fee, retail funds. A proxy for better markets and, particularly, the bull market in Asia, where Schroders is especially strong. To reiterate the investment appeal of a company of this type – Schroders' cash means it will not go bust (to put it crudely), yet the nature of its business offers the prospect for a levered share price performance in an equity bull market (a share price performance that might otherwise only be available in a much more operationally and financially leveraged – and therefore riskier, non-financial company). Given that stock markets spend most of their time going up and that missing out on big "up" days is one of the surest ways to underperform the equity averages over time, then, to us, owning conservatively-financed asset managers makes a lot of sense.

LSE We took advantage of the 10% gain in December to reduce this holding for the first time, as the dividend yield fell below 1.0%. We still believe that owning a piece of the London Exchange gives one a seat at an important game – the creation of a truly global securities marketplace.

Rathbone A cash-rich, well-reputed asset manager offering a dividend yield higher than the All-Share. We note that the dividend has more than doubled over a 10 year period when the All-Share's capital gain is scarcely 10%. This illustrates both the cash generative nature of Rathbone's business and the growth of the private wealth advisory industry, which Rathbone is locked into. Falling interest rates, rising UK savings ratio and bottoming capital markets in 2008 – will be good for the industry and for this share price.

HBOS Dividend cover of 2.3x on now confirmed 2007/8 earnings. Dividend yield 6.7%. Of course, loan growth will slow and bad debts will rise, but lots of discretionary consumer spending will be cut before people default on their mortgages. Savings division likely to enjoy several years of counter-cyclical growth. Meanwhile, HBOS earns less than 10% of its profits from capital market "trading", compare to Barclays/RBS at over 30%, meaning earnings quality is higher.

Lloyds Bank Offered a comforting trading update and is a bank likely to emerge from current sector woes stronger. Less than 7% of profits derive from trading activities – like HBOS this means the balance sheet is less exposed to dubious instruments than many. We dream of a significant domestic acquisition, which would allow the company to capture more economies of scale.

Reed Elsevier A wonderfully positioned business for 2008. Cash-generative, non-cyclical growth, with significant Dollar earnings. The European Media sector has underperformed for 7 straight years and is valued at a meaningful discount to its history. This at a time when some sector constituents are likely to demonstrate earnings growth in 2008/9, during a profit slowdown elsewhere. Likely to be the start of a prolonged period of outperformance for the sector and Reed in particular.

Sage A 95% dividend increase for 2007, announced in late November, puts the shares on a yield premium to the All-Share, probably for the first time in its quoted history. Reliably and exceptionally cash-generative, Sage is a big beneficiary of Sterling weakness. The 30,000 calls received every business day from its 5.5 million small company customer base confirm how crucial Sage is to them.

Reuters Shares performing well into likely regulatory approval of merger with Thomson. Still a double digit arbitrage profit to be earned from holding on.

Pearson Shares weak on fears of pending cuts in US state education budgets, although this is pure supposition. We assume Pearson Education is a steady growth business, about to benefit from integration of recently acquired assets from Reed. 62%-owned US subsidiary IDC was up 18% in Q4, now represents 16% PSON's market cap. Gap between latter and break-up value very wide.

A.G. Barr A cash-generative soft drinks business, with great brands, net cash on its balance sheet, a decent growth outlook and a dividend yield above the market average adds up to a buying opportunity, we think. The shares will not perform in the current environment, because investors are cautious of smaller UK companies with domestic earnings. However, this does not make Barr a bad company, nor anything but a fine long term investment.

Unilever A 7.5% share gain in December shows that investors begin to recognize the attractions of this business. Highly stable revenues, with an Emerging Market growth story and a developed world margin improvement opportunity. Another beneficiary of Sterling weakness.

Cadbury Shares unchanged on Trian increasing its stake to 4.5% and challenging Board, by public letter, to be more aggressive in releasing value. Trian's indicated target price of £9.70 not dissimilar to our own and suggesting significant strategic mispricing. Cadbury will see corporate action in 2008, if only the demerger of US soft drinks.

Diageo If interest rates and Sterling fall, Diageo could sustain a higher rating on higher earnings. The company has already repurchased 0.5% of its outstanding equity in 2008, on target for another 5-6% annual buyback. In our opinion this is highly accretive for non-selling shareholders.

And, separately,

Preference Shares Systemic worries about global banks have outweighed the high and, we expect, safe yields on these instruments. HBOS pref dividends covered 17x by ordinary dividends and over 200x for RBS. In any "normal" bad debt cycle these pref dividends are secure. Falling UK interest rates likely to increase investor hunger for income and these instruments, yielding over 8.0%, could generate attractive returns.

Postscript

Sir John Templeton is still with us, due to celebrate his 95th birthday in 2008 and his "Investment Maxims" and other words of wisdom are always worthy of consideration. Truly, Sir John "forgot more than we'll ever know about" equity markets. Today we recommend investors dwell on the following:

"To buy when others are despondently selling and to sell when others are greedily buying requires the greatest fortitude and pays the greatest reward."

"The time to buy stocks is when the short-term owners have finished their selling, and the time to sell a stock is when the short-term owners have finished their buying."

"Too many investors focus on "outlook" and "trends". Therefore more profit is made by focusing on value."

"An investor who has all the answers doesn't even understand the questions."

And my favourite - "History shows that time, not timing, is the key to investment success. Therefore the best time to buy stocks is when you have money."

The Nick Train SIPP has a bit of money in it and last week I purchased for it more shares in Finsbury Growth, our longest UK equity track record, on a discount of 5.0%. I don't know if we are at the bottom, but I do know that Finsbury Growth's portfolio comprises "sound common stocks", which others today are "despondently selling".

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