AFFINITY CONSULTING GROUP

March 5th 2007

Market Correction

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Introduction

Last week saw a much publicised drop in markets around the world. Is it something to worry about? Well no, not really. It is a correction to an over-heated market and as most of our clients are long term investors, it is not something to be overly concerned about. Particularly those investing in funds of funds (such as Lanson Financial & Collins Stewart) where the fund managers are allocating the assets for you. In particular Lanson Financial implemented their stop/loss strategy and all holdings in China & India were sold last week increasing their cash holdings to 65% in LIG & 62% in Optima

I have written this briefing to explain what happened and its possible impact

Simple summary of events

The markets have seen too rapid a period of growth for this to be sustained, particularly the emerging markets, and a correction was necessary to bring company shares back to more realistic valuations. Sudden shocks always unsettle markets and causes investors and fund managers to take profits and re-assess current strategies, resulting in continued volatility for a while. All markets are built on confidence and when this is dented, they become more unpredictable.

In this case, fortunately, there are no fundamental problems with the world economy or with underlying share valuation or interest rates. There is a possibility that investors, particularly hedge funds, who have borrowed in Japanese yen to buy risk assets (particularly shares) may now become more risk averse and sell the assets to repay the loans. This would prolong the downturn and volatility.

Investment strategy

The unpredictability of markets over the short term serves to show that investing monthly is a good way to save for the long term, particularly in volatile markets, as your money is invested at regular intervals over a long period of time. At times like this you are buying at lower prices. Over the long term, the markets are likely to recover, so the money already invested will regain the drop and continue to grow. The new money will buy more shares/units at the lower value and the extra growth on this offsets the slower growth on those bought at a higher level.

If you would like more information, please contact your usual Affinity consultant or send me an email.

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Market Correction

- Last week saw dramatic falls in equity markets accompanied by a rise in volatility.
- China was the initial spur, but other factors are at work.
- Financial market positioning triggered the unwinding of carry trades and a rise in spreads on risk assets.
- Fundamental picture remains sound.

Share markets are currently experiencing their sharpest fall since the spring of last year. My last newsletter did warn of a possible correction in emerging markets this year as they have experienced a long rise. The Chinese equity market led the way with a 9% fall on Tuesday morning. This spilled over into the rest of Asia and then to European and US equity markets later in the day and caused volatility for the rest of last week. The sharp moves in equity markets have also been accompanied by volatility in bond and currency markets, with US treasuries rallying sharply and an appreciation in the yen.

The falls in the major share markets in the last week are:

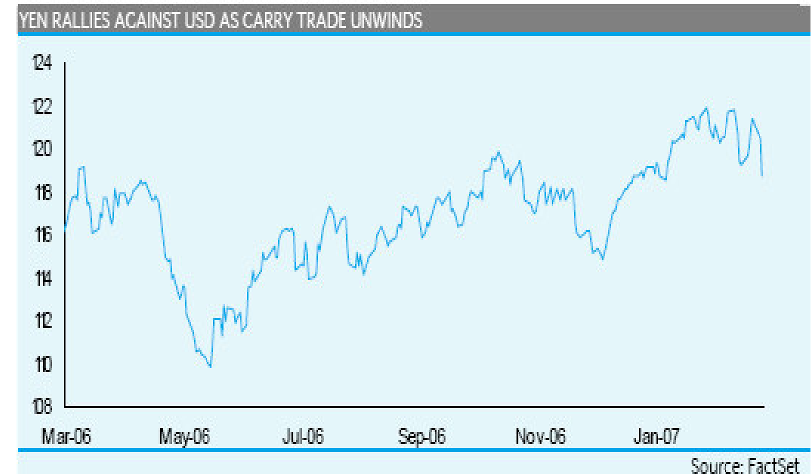
Dow Jones	4.2%	(USA)
S&P 500	4.4%	(USA)
FTSE 100	4.5%	(UK)
Euro STOXX 50	5.5%	(Europe)
Nikkei	5.3%	(Japan)
Hang Seng	6.1%	(Hong Kong)
Straits Times	7.0%	(Singapore)
Shanghai SE	5.6%	(China)
BSE Sensex	5.5%	(India)
Kuala Lumpur	9.3%	(Malaysia)

However, for those clients that we inherited from Lanson Financial in Singapore and others worldwide, our strategy of recommending Lanson Financial and Collins Stewart funds of funds has given considerable protection, as Lanson moved half of their funds to cash over a week before the markets fell and Collins Stewart had sold of most of their emerging market investments a while ago in favour of US assets. The falls in these funds last week were:

Collins Stewart Aggressive USD	4.4%
Collins Stewart Growth USD	2.6%
Lanson International Growth	2.9%
Lanson Optima	3.4%

However, the Templeton BRIC fund fell 7.5% over the week.

The blame for the latest sell-off is alleged to lie with developments in China, but this explanation alone is too simplistic. Increased speculation over the possibility of further action by the Chinese authorities to curb the intensity of the bubble in domestic asset markets is part of the story, as the Chinese stock market saw a very large rise last year, but the tightening in interest-rate policy in India and Japan in recent weeks is also to blame. The Indian market had already dropped by some 5% in the week before China dropped. In addition, there are the growing worries about developments in the sub-prime mortgage market (the weaker, less well secured loans) in the US.



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Market Correction

I have explained before that many investors have been borrowing in Japanese yen to finance other investments, (known as the "carry trade") particularly in emerging markets. The prospect of capital repatriation back into Japan – as the yen carry trade loses some of its allure – is a relevant factor. In this regard, it is interesting that the yen has actually rallied 4% against the dollar since the Bank of Japan made its move just over a week ago.

Overall however, most fund managers believe that the economic fundamentals are still sound and the US is not about to go into recession and that the emerging markets will continue to expand and grow. After the rapid rise in these markets, they were overheating and most fund managers anticipated a correction and view it as a positive move for the markets.

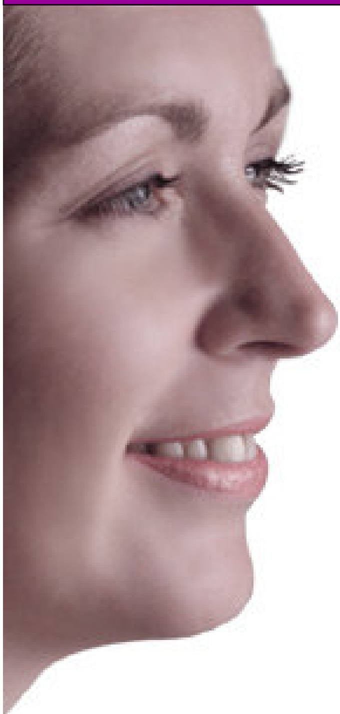
There are effectively two issues at play here:

1) Changing investor risk appetite and market volatility

- Increased volatility in equity markets has been expected for some time now. This correction is likely to create further short-term risk for equities and higher levels of volatility. This spike in volatility is resulting in a pick-up in the risk premium which is likely to constrain valuations in the short-term. However, corrections of this nature often present excellent longer-term opportunities. This is particularly true when they occur following periods of strong share-price gains with only limited changes to the financial economy, as appears to be the current case. Many fund mangers expect opportunities to emerge during this correction.
- The rise in risk aversion has caused the bond markets to rise over the week as investors moved out of equities and into bonds.

- The sharp fall in US durable-goods orders last week clearly exacerbated concerns in financial markets, as it came on the back of a downshift in data over the past few weeks and comments from Alan Greenspan highlighting the possibility of a recession in 2008. In part, the shift from stronger-than-expected economic numbers in December and early January to weaker figures is a reflection of the move from unseasonably warm weather to more normal temperatures. However, not all of the disappointments can be explained by this shift – hence there has been speculation that the economic news may continue to turn weaker and that markets may turn down. However, consumer spending is still holding up firmly and should continue to be supported by favourable trends in the labour market and income growth. With overseas growth still firm, it is likely that the industrial part of the US economy should recover over coming months. Hence, despite the likelihood of a sharp downward revision to q4 growth, growth is expected to accelerate back towards the trend as the first quarter progresses.

2) Equity valuations



Market Outlook

Overall, there is the potential for a further correction in the near term as investors struggle to re-price risk and volatility continues. The consensus amongst the major fund houses seems to be positive over the medium term and they believe that near-term risks will present long-term opportunities. Mostly they still favour equities against bonds.

The increased volatility in markets may have further to run, as a technical shake-out can become self-fulfilling as stop losses are triggered and risk appetite is scaled back sharply. With the Japanese year end approaching, further repatriation of capital may result in continued turbulence and the unwinding of yen carry trades, with implications for share markets. However, the fundamental picture has not deteriorated in a material way and, unlike last June, there is no evidence that central banks have fallen behind the curve in terms of monetary policy. Interest-rate futures contracts continue to imply that an easing in policy (reduction in rates) is more likely as the year progresses than a further tightening. This is also visible in the behaviour of the bond market, where US Treasury yields remain well within existing trading ranges rather than pushing up to new highs as was the case back in the spring.

Fundamental Principles of Investing

Nobody can predict market corrections or bull and bear markets. Investors place their money for the medium to long term. Speculators look for short periods of investment with high gains and are prepared to take higher risks. Most of our advice is aimed at investors rather than speculators as investors form the majority of our client base.

Rather than focussing on individual markets or sectors, investors may be better off holding a well diversified portfolio, both within markets and internationally. Anyone with sufficient funds should be looking to invest a portion of their assets in global markets: in the rest of Asia, in Europe and in the Americas. This spreads risk and lowers the volatility of a portfolio. So, for the bulk of your assets, good advice would be:

1. Think about how much risk you are prepared to take; then determine a mix of equities, specialised funds (such as commodities and property) and bonds that you are comfortable with.
2. Invest regularly; do not try to time either equity or bond markets.
3. Don't chase hot markets; build a broad-based and well-diversified portfolio.
4. Use an asset manager (typically a fund of funds manger) to allocate your investments to markets.
5. If you do want to manage the asset mix of your portfolio, try to buy cheap, unfashionable assets and sell expensive ones (most investors seem to do the opposite).
6. Only invest in hot markets or fashionable sectors with money that you are prepared to lose.

What's in favour?

- Long-dated index-linked
- High Yield Bonds
- Mid Cap Equities
- Commodities
- Alternative assets
- Property

That does not leave much. What's out of favour?

- Cash (as this destroys value)
- Large cap equities (globally)

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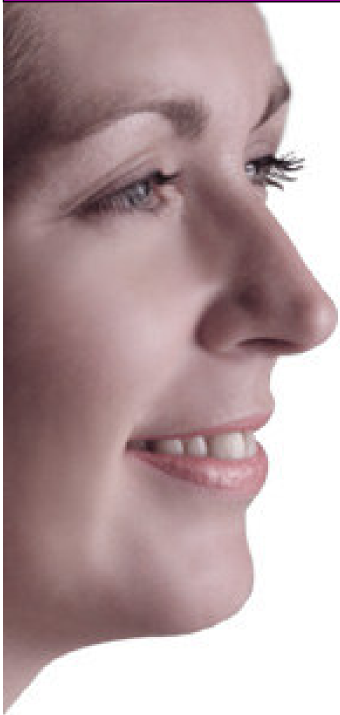

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