

# BARRATT & COOKE

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5<sup>th</sup> October 2007

|                    | <u>1/1/00</u> | <u>1/1/01</u> | <u>1/1/02</u> | <u>1/1/03</u> | <u>1/1/04</u> | <u>1/1/05</u> | <u>1/1/06</u> | <u>5/10/06</u> | <u>1/1/07</u> | <u>5/4/07</u> | <u>1/7/07</u> | <u>5/10/07</u> |
|--------------------|---------------|---------------|---------------|---------------|---------------|---------------|---------------|----------------|---------------|---------------|---------------|----------------|
| FTSE 100           | 6930          | 6222          | 5217          | 3940          | 4477          | 4814          | 5618          | 6005           | 6220          | 6397          | 6608          | 6596           |
| FTSE All Share     | 3242          | 2983          | 2524          | 1894          | 2207          | 2411          | 2847          | 3076           | 3221          | 3332          | 3404          | 3387           |
| Dow Jones (US)     | 11452         | 10786         | 10022         | 8342          | 10454         | 10783         | 10717         | 11867          | 12463         | 12560         | 13408         | 14066          |
| S&P 500 (US)       | 1469          | 1320          | 1148          | 880           | 1112          | 1212          | 1248          | 1353           | 1418          | 1444          | 1503          | 1558           |
| Nikkei Dow (Japan) | 18934         | 13785         | 10543         | 8579          | 10677         | 11489         | 16111         | 16436          | 17225         | 17491         | 18138         | 17065          |

## Leading Growth Equities

Caledonia Investments  
Diageo  
Experian Group  
Hammerson  
Johnson Matthey  
Land Securities  
Prudential  
SAB Miller  
Smiths Group  
Tesco

## Leading Income Equities

Aviva  
BP  
BT Group  
Lloyds TSB  
Royal Bank of Scotland  
Segro  
United Utilities  
Yell

## Smaller Companies

Biffa  
Cobham  
Forth Ports  
Halma  
Hikma Pharm  
Northumbrian Water  
Quintain Estates  
VT Group

## Overseas Companies

LVMH  
Nestlé  
PepsiCo  
Procter & Gamble  
Woodside

## AIM Stocks

Cape  
Domino's Pizza  
Lok'n Store  
Majestic Wine

## Overseas Funds

Henderson TR Pacific IT  
JPM American IT  
JPM Indian IT  
Monks IT  
New Star European Growth OEIC

## INTRODUCTION

To me, the run on Northern Rock, and its near bankruptcy, has been one of the most profound incidents to hit 'The City of London' in my 40 years Stockbroking experience.

This is the first time there has been 'a run' on a major UK bank for 140 years and it has rocked confidence and trust in 'The City' to the core. However, the Bank of England has survived; 'The City of London' has survived; the UK Banking industry has survived; though Northern Rock looks unlikely to survive as we know it. These events have been so profound within 'The City', and its motto of 'My word is my bond', that I make no excuse discussing 'The Northern Rock debacle' at length in this chronicle.

I am also delighted that other members of Barratt & Cooke have contributed to this Newsletter, as they will in the future:

John Everall  
William Barratt  
Will Mellor

UK and Foreign Stockmarkets  
Investment Trusts, PEPs and ISAs  
Fixed Interest and Corporate Actions

## 'AN OLD FASHIONED CREDIT SQUEEZE'

Readers of these chronicles have been shocked by the extraordinary events in Stockmarkets since 1<sup>st</sup> July 2007 and have clearly appreciated Barratt & Cooke's two updates:

|                                 |                      |
|---------------------------------|----------------------|
| 16 <sup>th</sup> August 2007    | 'Stockmarket Update' |
| 17 <sup>th</sup> September 2007 | 'The Banking Sector' |

Indeed, a 'steady nerve' and a 'balanced portfolio' has been rewarded, with the FTSE 100 recovering from 5859 on 16<sup>th</sup> August 2007 to today's 6596.

Now, let us look back and ask the questions:

- 1) Why did Northern Rock appear to fail?
- 2) What actions have been taken?
- 3) What are the lessons learnt?
- 4) Could it happen again?

To answer these questions, it is helpful to look back into history:

- a) The last run on a major UK Clearing Bank was 140 years ago, at the time that 'Barclays Bank' had to rescue 'Gurney's Bank'. This event has lived in Norfolk folklore ever since!
- b) My father, who joined Barratt & Cooke in 1928, used to talk to me in the cradle about the '1929 Crash', with mayhem outside US banks, while bankers and financiers jumped off roof tops like lemmings to the slaughter.
- c) I can remember the 1974 'Secondary, Tertiary Banking Crisis', caused by banks lending too much on property speculation which had had a constant rise since 'the Barber Boom' after the times of MacMillan, who famously said "You've never had it so good".

This boom ended in chaos, the Bank of England Lifeboat and Denis Healey going 'cap in hand' to the International Monetary Fund (IMF) and issuing Gilts on a coupon of 15½%, while RPI reached 21%, and Harold Wilson referring to "the pound in your pocket!"

- d) There was the Japanese Banking Crisis of the 1990's, again caused by the excessive lending on the ever rising values of Property and Stockmarkets, where the Nikkei Dow reached 40,000 to fall back to 8579 on 1<sup>st</sup> January 2003 and has only now recovered to today's 17065.

Unbelievably in this global, technological, regulated, compliant age of 2007, the UK experiences its first major run on a FTSE 100 Bank, Northern Rock, for 140 years. The Bank of England has to stand in with a 'Lifeboat Fund' and in the nick of time restores credibility and stability to a severely shaken banking system.

When this Newsletter is read in 20 years time, it will seem incomprehensible that there was a complete meltdown of confidence in the UK banking system for 2 weeks in September 2007, with queues and mayhem outside branches of Northern Rock.

### WHY DID THIS HAPPEN TO NORTHERN ROCK?

One first has to look back to Alan Greenspan's 'monetary policy' in the US, lowering US interest rates down to 1% in 2004 to stimulate the US economy and buy its way out of recession. Greenspan was considered a financial genius, but he was only sowing the seeds of an eventual disaster.

Like in MacMillan's time, the US economy had 'never had it so good'. Investment bankers had started to use every type of derivative and financial instrument to create the 'new monster' - the Hedge Fund. With this apparent new wealth, the banks appeared to have so much 'cash' that they just did not know what to do with it.

Out of this apparent weight of cash, US banks started lending ‘willy nilly’ to the new market place, ‘the US Sub Prime Mortgage Market’. This is a rather dismissive term, actually meaning ‘lending to the poor and often uneducated US citizens’. Though ‘poor and uneducated’ these citizens had enough sense to know a bargain when they saw one. To borrow money at 1%, even on vastly inflated values of low grade properties, was too good to be true.

But, as US inflation started to take off, stimulated by low interest rates, Greenspan had to raise the base rate (the US Federal Funds Rate) from approximately 1% to 5¼%. This meant that many of these ‘Sub Prime Mortgage rates’ rose from 1% to 8%, which of course the ‘poor and uneducated’ could not pay, creating bankruptcies, forced sales of dud properties, and much wailing and gnashing of teeth.

These bankruptcies and losses have pushed US Banks to the brink, with huge losses being announced every day from the likes of Goldman Sachs, Morgan Stanley, Citigroup and worldwide banks, HSBC and UBS etc. This has created a worldwide banking crisis where banks are even scared of lending to other banks, thereby creating a total shortage of ‘short term credit’ in the global banking industry. In other words ‘AN OLD FASHIONED CREDIT SQUEEZE’.

It is the US Sub Prime borrowers that are being blamed, but I would ask ‘Who were the stupid and irresponsible people, the borrowers or the lenders?’ I have absolutely no sympathy with the greedy, get rich quick, investment bankers, who are now being pursued for ‘mis-selling’, and so the gravy train will end up with the US lawyers yet again!

These global banks do have huge reserves and can take these knocks, just as a heavyweight boxer in a 12 round contest. But it is the weak that have not built up their reserves, that are knocked out in the first round.

In Northern Rock’s case, it had a unique ‘business model’ unlike most other UK banks or building societies. The vast majority of its funds were raised from the ‘global short term money markets’ and lent ‘long term for mortgages’.

This ‘business model’ was perfectly legal and had worked very well. Why go to the expense of running branches to collect depositors money while the money markets were awash with money?

But Northern Rock has fallen into the oldest trap in the world, ‘borrowing short and lending long’, which is absolutely fine when ‘short term credit’ is there, but immediately it dried up Northern Rock was knocked out in the first round.

Ironically, with no short term credit in the global markets, Northern Rock had to ask its own bankers (The Bank of England) for credit (i.e. a loan). Immediately this news was made public knowledge rumours of bankruptcy spread and in no time at all the world and his wife panicked and quite sensibly withdrew funds from Northern Rock. The panic spread like wild fire. There was an old fashioned ‘run on the bank’ and confidence lost for ever.

### **WHAT ACTION HAS BEEN TAKEN?**

Gordon Brown has been considered a genius for breaking away the Bank of England monetary policy from the Government. This means the Bank of England sets interest rates in order to control inflation which, so far, has proved a stroke of genius (Gordon Brown was not such a genius when he sold part of our ‘gold reserves’ at US\$280 an ounce!).

During the Northern Rock crisis, where the FSA, the Government and the Bank of England should have been working in unison, they have all been working at logger heads, causing further delays and further confusion.

On the interference of the Government, the Bank of England has:

- a) Agreed to guarantee existing deposits at Northern Rock
- b) Lent Northern Rock an estimated £8bn
- c) Agreed to lend £10bn short term credit to the UK banking system (though no UK banks took up this credit due to the higher interest rates and the stigma now associated with borrowing from the Bank of England)

and could shortly reduce interest rates from base rates of  $5\frac{3}{4}\%$ .

Though many financial commentators criticise the Government and the Bank of England, likening these moves to a panicking Banana Republic, I totally disagree, even though these moves:

- a) Have strengthened Sterling
- b) Could increase inflation

I do feel that the moves are correct to restore confidence to the UK banking system and 'confidence' is the most important word in any banking system.

### **WHAT HAVE WE LEARNT FROM THESE EVENTS?**

- 1) The FSA (the 'City Watchdog') must be more aware and more concerned about the present financial instruments of derivatives, hedge funds, stock lending, global credit etc etc.

It worries me that few people understand derivatives and hedge funds. Many banks do not know their own liabilities and these 'monsters' must be monitored and regulated on a global basis before there is another disaster. Like Topsy they have grown out of control.

- 2) Banks/Building Societies have 'guarantees' which cover deposits of up to £35,000 in full.

The Government in conjunction with the Bank of England will now look at ways to increase this to £100,000 in the future.

Barratt & Cooke is not authorised to give advice on individual Building Society Deposits.

- 3) The Bank of England is the banker to the UK Banks and has bailed out Northern Rock correctly, albeit in a confused shambles.

The UK banking industry has proved it can sustain a sudden 'run' and should actually be an even stronger 'animal' after these events.

### **COULD IT HAPPEN AGAIN?**

The answer should be 'no' from the experiences learnt so far.

But, I am afraid the answer is:

'Very unlikely, but yes'

Barratt & Cooke still worries about the excessive liabilities that world banks have from speculating in Derivatives and Hedge Funds and the more I ask and the more I enquire, I realise that less and less people understand them, let alone the possible liabilities involved.

Following numerous Hedge Funds now going bust (I thought a 'Hedge' was meant to be safe!), I misquote Warren Buffett:

“When the Hedge is taken down, you can see those who have been sunbathing topless behind it.”

This says it all.

However, I do feel that with the huge reserves the UK Clearing Banks have built up over many years, they are indeed heavyweights in a 12 round contest and the sector appears undervalued.

This is all hindsight now - and all but for the grace of God, very few Barratt & Cooke clients held Northern Rock shares.

### **UK EQUITY MARKETS (by John Overall)**

Despite the volatility in the UK Stockmarket over the summer as a result of the ‘credit crisis’, the major indices have moved higher since the beginning of the year:

|                | <u>1/1/07</u> | <u>5/4/07</u> | <u>1/7/07</u> | <u>5/10/07</u> |
|----------------|---------------|---------------|---------------|----------------|
| FTSE 100       | 6220          | 6397          | 6608          | 6596           |
| FTSE 250       | 11178         | 11916         | 11528         | 11390          |
| FTSE All Share | 3221          | 3332          | 3404          | 3387           |

As we predicted in the April Newsletter, the FTSE 250 has underperformed the FTSE 100 so far this year.

The strength of UK Stockmarkets can be explained by:

- 1) UK ‘corporate profitability’ still rising with many companies cash rich, enabling:
  - a) Healthy dividend rises
  - b) Large share buy-backs
  - c) Attractive special dividends
  
- 2) Rising corporate profits has meant the rating on the FTSE 100 index is still modest:

|                        |   |          |
|------------------------|---|----------|
| Average PE ratio       | = | 12.2x    |
| Average dividend yield | = | 3.0% net |
| Average dividend cover | = | 2.7x     |

These are historically attractive ratings.

At the same time, looking at individual sectors, we do consider:

|                        |   |
|------------------------|---|
| <i>Mining Shares</i>   | Fully valued, but right to retain a proportion in Mining  |
| <i>Property Shares</i> | REITs look too low on large discounts to NAV (Net Asset Value)  |
| <i>Bank Shares</i>     | Some banks now look good value following the fall in Bank shares, especially:<br>Royal Bank of Scotland |

## **OVERSEAS MARKETS (by John Overall)**

- US** US markets have recently rallied to new highs due to the ½% cut in interest rates. The US economy continues to grow at approximately 3%, and US stocks with emerging market exposure, such as:
- PepsiCo
- look attractive. Also, the dollar is likely to appreciate as other countries follow the US and reduce interest rates.
- Europe** The rising Euro is threatening European exports and Eurozone growth rates for 2008 are being reduced. We like:
- LVMH (Louis Vuitton, Moët Hennessy)
- with its strong Chinese business, or a broadly spread fund:
- New Star European Growth Fund
- Japan** Second quarter economic growth was negative and there are worries that deflation might reappear. New Prime Minister Yasuo Fukuda has been well received, but we are cautious.
- Emerging Markets** China and other Far Eastern markets continue to show strong growth. Inflationary pressures are increasing, but the medium term outlook is positive. We suggest:
- Henderson TR Pacific
- for Far East exposure and:
- JPM India
- for the Indian Market.
- Australia** Rising commodity prices have enriched the Australian economy, where we like:
- Woodside
- Australia's largest Oil company.

## **INVESTMENT TRUSTS (by William Barratt)**

As you are probably aware from the July Newsletter, I joined Barratt & Cooke in June, having worked for a Stockbroking firm in London for 5 years. Part of my remit at Barratt & Cooke as the 'Business Development Manager' is to find ways to help take the business forward, whilst using past experiences to add value to our current advice. I shall therefore be writing in forthcoming Newsletters on a number of different topics which, hopefully, you will find of interest. I have also spoken to a number of clients already in my capacity as a dealer.

One of my major roles whilst in London was to lead the Investment Trust research and I have therefore been fortunate to make a number of contacts in the Trust arena. Consequently it seemed sensible that my first project at Barratt & Cooke would be to review the Investment Trust holdings.

The Investment Trust vehicle is an excellent tool for all clients, however I am keen to distinguish how it should be used:

- 1) For clients with funds under management of **less than £50,000**, the Trust universe provides a solution to obtaining a diversified portfolio with minimal dealing costs. Income, growth and global diversification can be achieved through the purchase of a few Trusts.

To achieve this end our preferred Trusts are:

|                               |                   |
|-------------------------------|-------------------|
| Bankers and Scottish Mortgage | for global growth |
| Merchants and Murray Income   | for income        |

All of these Trusts, bar Scottish Mortgage, have a strong bias towards the FTSE 100 and therefore clients would have exposure to the UK market without holding the direct equity themselves.

- 2) Clients who have portfolios in **excess of £50,000** are likely to hold individual FTSE 100 shares and in order to avoid duplication we will look to move out of the generalist Trusts when appropriate in favour of more specialist funds. For these clients the investment trust offers an opportunity to enter specific geographical markets and different asset classes by buying a portfolio of stocks rather than taking on the risk associated with an individual share.

When selecting an Investment Trust we believe the most important factor is strong management. Other criteria we examine closely include; liquidity, discount, focus, gearing and portfolio turnover.

Below is a list of our favoured Trusts in sectors which we believe currently represent good value:

|                                 |  |
|---------------------------------|--|
| <i>Specialist Global Growth</i> | Monks<br>Caledonia                                   |
| <i>Private Equity</i>           | Candover   |
| <i>Smaller Companies</i>        | JPM Smaller Companies<br>Aberforth Smaller Companies |
| <i>Europe</i>                   | JPMF Continental                                     |
| <i>Asia ex Japan</i>            | Henderson TR Pacific<br>Pacific Horizon              |
| <i>Property</i>                 | TR Property Trust                                    |

### **FIXED INTEREST (by Will Mellor)**

Following the US Sub Prime Mortgage Crisis, the US Federal Reserve has reduced its base rate from 5¼% to 4¾%, which in turn has seen the US Dollar depreciate against other leading currencies. It would now seem likely that, following the 'Northern Wreck' fiasco, the Bank of England will reduce its base rate from 5¾% (though we feel this would be inflationary and a pity at this stage).

As you can see from the enclosed 'Fixed Interest Chart', Conventional Gilts have anticipated a drop in base rates, with:

Yields falling from 5.75% to 5.0%

It will soon be necessary to switch:

5% Treasury Stock 2008

into longer dated stock.

However Eurobonds have held steady and now yield 6.5% gross, whereas Preference Shares have become very attractive, giving yields of:

|                  |      |
|------------------|------|
| Net              | 6.7% |
| Equivalent Gross | 8.4% |

(Clients should however be aware of volatility and liquidity in Preference Shares).

Now that RPI has risen back up to 4.1%, we still particularly like:

Index Linked Gilts

and it will soon be necessary to switch:

2½% Treasury Index Linked Stock 2009

into longer dated stock.

### **CORPORATE ACTIONS (by Will Mellor)**

With the drying up of credit, corporate activity has slowed considerably over the summer months with fewer:

Special Dividends  
Mergers  
Takeovers etc

However, since 1<sup>st</sup> July 2007 we have written to clients on:

#### Special Dividends and Consolidations

3i Group  
Kelda  
Segro  
Smiths Group

#### Takeovers and Mergers

Alliance Boots  
Hanson  
Taylor Woodrow/Wimpey  
EMI

whilst the pending takeovers of:

Imperial Chemicals Industries  
Reuters  
Sainsbury (J)

all appear to still be on the cards.

We have recently written to all shareholders in:

The London Stock Exchange

with two Arab countries (Dubai and Qatar) taking a large stake in the London Stock Exchange, this looks very exciting for shareholders.

We shall ensure all clients are informed as corporate actions take place.

### **PEPs/ISAs (by William Barratt)**

We wrote to PEP and ISA clients at the beginning of the year explaining that PEPs would become ISAs on 6<sup>th</sup> April 2008. We asked those who wanted Barratt & Cooke to manage all their tax efficient wrappers to let us know if they held PEPs and ISAs elsewhere.

We are now setting the project in motion and will be writing to clients shortly to request valuations.

**If we receive the transfer form by Monday 7<sup>th</sup> January 2008:**

Barratt & Cooke will not charge a commission on the initial investment of cash.

Barratt & Cooke will not charge the half yearly management fee on the transfer value of the portfolio (for the period to 5<sup>th</sup> April 2008).

We feel it must now be sensible to get all PEPs and ISAs under one roof so that these can be amalgamated on 6<sup>th</sup> April 2008. Barratt & Cooke can then manage your total portfolio to prevent duplication, look at the whole picture with a view to asset allocation, and make the most of the tax efficient wrappers. If you have not notified us of PEPs and ISAs elsewhere and would like us to arrange the transfer, please let your advisor know.

As well as the amalgamation of PEPs and ISAs, as of 6<sup>th</sup> April 2008, cash ISAs and TESSAs can be converted to stocks and shares ISAs, although this will be a one way transfer and will have to hold investments rather than cash.

Clients should always endeavour to utilise their annual ISA allowance, which from 6<sup>th</sup> April 2008 will be increased to £7,200.

**CAPITAL LOSSES CARRIED FORWARD**

As most Tax Returns have been completed for 5<sup>th</sup> April 2007, could all clients who have capital losses carried forward from 2006/2007 please inform Barratt & Cooke of these losses by completing and returning the enclosed blue form, so that we can take these into account when giving you investment advice.

**THE ROYAL MAIL POSTAGE STRIKE**

This is just one more example of the benefit of Barratt & Cooke's:

**Nominee Service**

No transfers and certificates.

Dividends direct to bank account.

**Discretion**

No transfers and certificates.

Dividends direct to bank account.

No advice letters need to be read or answered.

Barratt & Cooke deals immediately a decision is made.

**Barratt & Cooke Client Deposit Account**

Cash deposited with Bank of Scotland.

No cheques required on buys and sales, as settlement can take place in this bank account.

We apologise for any delays on any 5<sup>th</sup> October 2007 valuations, or Newsletters. Everything has been prepared in time, it is now up to the Royal Mail.

## **DISCRETION**

Over 33% of Barratt & Cooke's 'funds under management' are now in our Barratt & Cooke Discretionary Service, which works incredibly well.

Clients should now ask the question "Why are we not in Discretionary Management?" rather than "Why should we be in Discretion?"

If any clients need further advice on the Barratt & Cooke Discretionary Service, then please do not hesitate to contact your advisor.

## **MiFID**

You should be aware that a new EU directive, the Markets in Financial Instruments Directive (MiFID), will come into force on the 1<sup>st</sup> November 2007. This will result in a number of changes to the rules of the Financial Service Authority (FSA) which regulates Barratt & Cooke. Please find enclosed, within your pack, details of the main changes MiFID will introduce.

## **STOP PRESS NEWS**

Keiron Fallon wins the Prix de l'Arc de Triomphe on Dylan Thomas and will now spend the next six months in the 'Old Bailey' on race fixing allegations.

Lewis Hamilton spins off the track at 10mph in Shanghai and will have to wait until the last Grand Prix of the season to be hailed champion.

Against all the odds England beat Australia and France beat the All Blacks, to set up the 'Stade de France' on Saturday, followed by .....!

This all goes to show that a day in sport is a very long time.

But, Gordon Brown has 'funked' the General Election and two more years will seem like an eternity.

## **PAUSE FOR THOUGHT**

Yet again the woes of Northern Rock has endorsed that old biblical saying:

"That unto every one which hath shall be given;  
and from him that hath not, even that he hath shall be taken away from him."

How true, how true.

**C W L Barratt and others**

**5<sup>th</sup> October 2007**

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