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4 December 2008

"Don't Panic"

Over the last few months the news from global equity markets has been nothing short of cataclysmic. Indeed, by some measures the falls we have seen now rank as the worst twelve months on record, not just since the depression in the 1930s, but since 1825. If this is the case, and what we have seen represents a unique event in global economic history, then the question needs to be asked: why stay with equities, even now?

I have listed below ten reasons why I believe that investors would be very badly served by panicking out at this late stage.

Before I list them, however, there is no point avoiding the mistakes we, alongside most of the financial world, made early in 2007, when the current series of crises began to break upon our heads: we were too sanguine about the prospects for the global economy; we underestimated the effect that the deep-seated problems in the US housing market would end up having throughout the financial world; we failed to appreciate just how pernicious the effects of unwinding financial excess would be both on banks and on markets - indeed, in common with many bank directors at the time, we were unaware of the hidden credit excesses in SIVs and other off-balance sheet vehicles; and we did not foresee how deeply the crisis would hurt a wide array of sectors.

But that was then, and this is now. It would be foolish to expect markets to continue to implode from here for the simple reason that they have come down by so much already. So here are ten reasons to stick with them:

1. Government and central bank intervention is unprecedented in the scale and the speed of its delivery. Authorities have made it clear they will expend every effort to ensure the recession does not grind into a depression. Their armoury is by no means exhausted.

    i. The global banking system has been recapitalised to the tune of trillions of dollars.

    ii. Special facilities have been provided to allow continued liquidity to feed the financial system, again, in mind-boggling amounts.

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iii. Large amounts of bad debts are being taken off the hands of the banks.

iv. Tax cuts are assisting the consumer across the globe.

v. Interest rates have been cut very sharply.

vi. Growth in money supply has been very high.

vii. Actions are being co-ordinated worldwide, adding ‘bang’ for the ‘buck’.

viii. Government spending has been allowed to increase sharply, mitigating the economic downturn.

2. Inflation is falling rapidly. This will allow central banks to cut rates sharply, even after recent very aggressive moves. Crude is down to below $50 per barrel compared with a peak of nearly $150 per barrel.

3. Investor pessimism is at extreme levels. This is a lagging, not a leading indicator.

   i. Volatility is at its highest level since 1987 and 1930.

   ii. Fund redemptions are at all time highs in the US.

   iii. The equity risk premium (the premium we are paid to take the additional risk inherent in equity investing), by just about whatever formula you choose to measure it, is at record levels. All the risk is priced into equities, and none of the upside.

4. Market top-down earnings forecasts now discount worse profitability than in previous lows. In the corporate bond market implicit (expected future) default rates are higher than in the depths of the Great Depression.

5. Director share purchases are at an all-time high and top quality long-term investors such as Warren Buffett and Anthony Bolton are now buying the market.

6. The UK equity market is now trading at around 9x (depressed) 2009 earnings estimates. This level of valuation is appropriate to a time of high, not falling inflation.

7. The yield on the UK equity market is very close to the yield on government bonds, which implies zero dividend growth over the next 10-15 years. With the collapse of inflation we can expect gilts to rally strongly at the short end, making the relative valuation of equity income still more attractive.

8. History shows that buying equities when they are lowly rated produces superior ten-year compound real returns. In the UK there is a 70% correlation between the valuation at which you buy shares and the extent of ten-year returns thereafter.

9. Equities hit their trough between six and fifteen months before the economy hits its trough. Earnings momentum has already collapsed. Markets begin to discount normality well before it is apparent.

10. Three times out of four, the market rallies sharply after a fall of more than 20%. In 1975 the UK market shot up by nearly 100%. In the 1930s the US equity market rose by over 200% from the end of 1932 to the end of 1936.

This is not to say a recovery will occur immediately. Amongst the catalysts that are required, we need to see a normalisation of the spread between LIBOR and short-term interest rates (which does appear to be happening, slowly), for corporate bond yield spreads with government stock to narrow, and for housing markets to stabilise in the UK and especially in the US.

Even without these factors in place, however, it is too late to sell. Given the magnitude of rallies after market falls of the extent we have seen these last 18 months, it is almost never possible for those who have cashed up to reinvest in time to capture them. Failure to participate in these strong periods has a very damaging effect on investors' long-term returns.

At Principal we are looking to exploit the pricing anomalies that are being thrown up by markets at the moment. In particular we are adding corporate bond exposure to our portfolios. After its worst six weeks on record, we believe this asset class now offers equity style capital upside and very significant yield attractions at a time when the returns on cash are trending towards zero. This is balanced by reductions in our exposure to highly defensive, but very expensive areas of the market and to cash.

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