Investment Bulletin

SAUNDERSON HOUSE

17 NOVEMBER 2006

FOCUSED FINANCIAL ADVICE

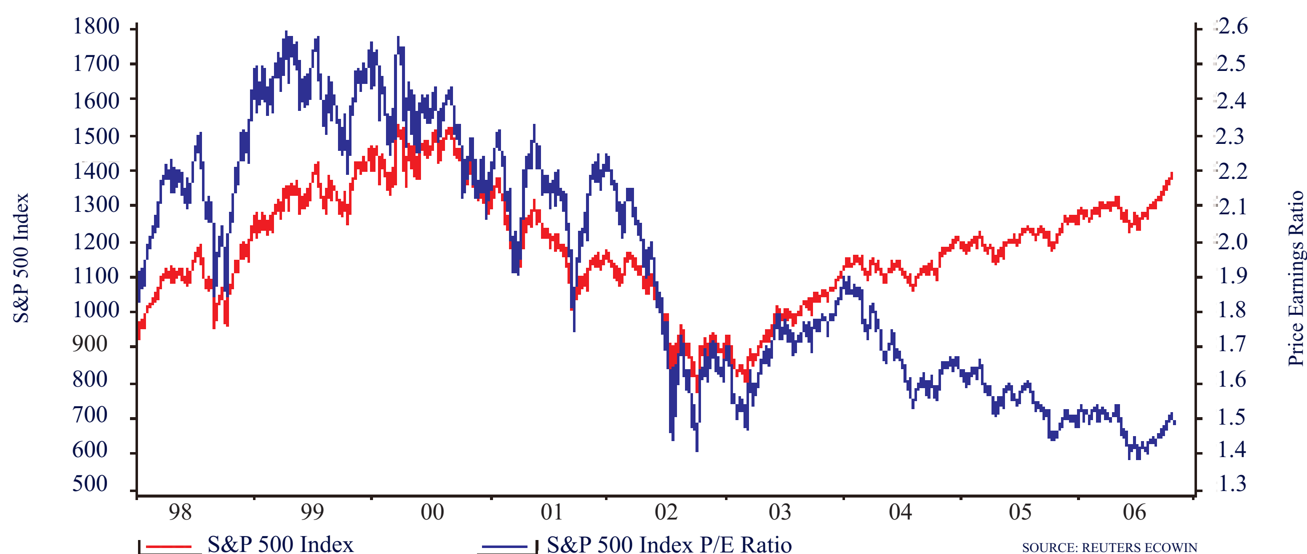
US EQUITIES - RETURNING TO AMERICA FOR THANKSGIVING

US equities have been the laggard among the world's major equity markets in recent years. If an investment of $100 had been made into US equities, it would have grown in value to just $131 during the three year period up to 31 October 2006. This compares poorly to an investment of £100 into UK equities, which would have grown to £148 over the same period, and to Europe where €100 would have grown to €163. Even Japan, which has had its share of economic woes, would have provided a better home for an investor's cash, with ¥100 growing to ¥155 over the three years. This is not the whole story though. Adjusting for the dollar's 11% depreciation against sterling, returns from US equities have been worse with £100 invested into US equities growing to £117.

The underperformance of the US market can be attributed to three factors: (a) at the start of the period US equities were relatively highly valued when measured by price-to-earning ratios; (b) the restructuring potential of continental European companies and the superior economic growth achieved by the Far Eastern countries made these countries more attractive to investors; (c) the US twin-deficits, particularly the US current account deficit, led to concerns that the US dollar might weaken sharply against other currencies thereby reducing returns for dollar denominated assets.

As highlighted below, we now believe that the drivers of US equity market underperformance are now easing. Having benefited from a low allocation in our model portfolios during the last two years, we are now recommending that clients begin to increase exposure to US equities.

Despite rising in value, US equities have become relatively less expensive due to strong earnings growth



- The chart above shows that the US equity market, when measured in terms of price-to-earnings ratio (blue line), is now less expensive than it was at the start of the decade. This is because share price rises (red line) have not kept up with strong corporate earnings growth.

- The US dollar has fallen by 8% against the euro during the first ten months of this year and by 11% against sterling over the same period. On purchasing power parity measures, which compare the prices of goods within different countries, the US dollar now appears undervalued. We therefore consider further substantial falls unlikely.

- With the dollar having fallen and the Federal Reserve indicating that cuts in US interest rates are not imminent, we believe it is un likely that the current account deficit will present problems in the short term. Indeed, with the US economy set for a period of slower growth, the deficit may begin to ease.

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