

BROMPTON PRIVATE CLIENTS

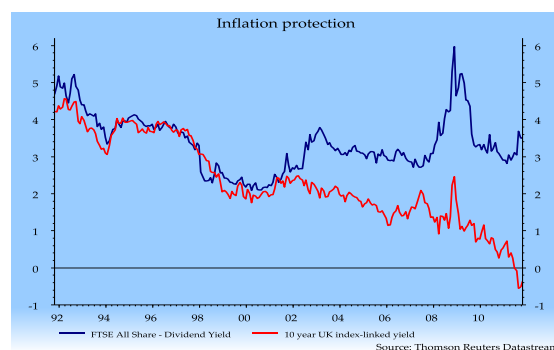
Quarterly review for the three months to 30th September 2011

Our last quarterly newsletter discussed the attractions of investing in a global infrastructure fund as an investment with the potential to protect real spending power in inflationary conditions. In the last few days, the September inflation figures have been released showing that UK inflation measured by the Consumer Prices Index (CPI) is now running at 5.2%. CPI inflation has never been higher than this since the measure was introduced in 1997 and it has only matched this level once before - in September 2008. The Bank of England governor and many economic commentators are confident inflation is currently running at this elevated level because of the impact of VAT increases and the recent sharp rises in energy and import prices. Mervyn King believes inflation is at or near its peak and will fall sharply next year. This is part of the justification for the recent unanimous decision by the Bank's monetary policy committee to increase the funds available for quantitative easing, the process by which the Bank is increasing the money supply, by a further £75 billion. This policy is widely regarded as inflationary but necessary to counteract the opposing deflationary forces created by the deleveraging of both the public and private sector balance sheets that is currently underway. If the Bank is wrong in anticipating a fall in inflation then quantitative easing will only add fuel to the flames.

Mervyn King says inflation will fall back because domestically-generated price rises are low and likely to remain so as a result of the weak economic growth and the spare capacity in the economy suggested by high unemployment. As he sees it, inflationary pressures are coming from external factors such as import price increases and energy costs. It is, however, likely that inflation will prove more persistent than the governor expects. The UK's high debt burden, low growth and increasing money supply may lead to further sterling weakness and no relief from imported inflation. Energy prices may also remain stubbornly high because the

development in emerging markets is commodity intensive. Thus, demand for oil and many other industrial commodities will not subside. The recent "flight to safety" buying of sovereign bonds means the gilt market is also pricing in exceptionally low interest rates and inflation expectations and, from the Bank's point of view, helpfully keeping down the cost of servicing the UK's debt burden. Markets are not pricing in the risk that inflation proves more difficult to bring under control. Bond yields currently imply we are in the grip of Japanese style deflationary forces.

In the face of such strong consensus opinion, the risks of persistent inflation have arguably been too readily dismissed. Private investors are concerned at the negative real returns on offer to savers and are seeking ways of protecting capital in real terms. The National Savings latest index-linked savings issue was withdrawn following strong demand. National Grid recently issued a 10-year inflation-linked bond, which then went to a premium to its issue price, and other companies are expected to issue similar instruments to meet unsatisfied demand for inflation protection. As the chart below highlights there are signs that many investors are not convinced inflation is set to fall back. The decrease in UK index linked gilt yields indicate demand from investors wishing to protect against future inflationary pressures. We believe investors are looking for real returns in the longer term so we continue to look for investments with the ability to perform well in an environment of persistent inflation.



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At the time of writing, it would be impossible not to comment on the eurozone sovereign debt crisis. Stockmarket volatility remains elevated while investors wait to see if substantive policy action is agreed in the wake of the emergency Group of Seven summit called to stop the debt crisis further damaging the fragile global economic recovery. There seems to be no silver bullet that will at once restore confidence to markets and also be palatable to the stronger eurozone nations, notably Germany. Chancellor Merkel has repeatedly voiced her opposition to the issuance of eurobonds guaranteed by eurozone member nations as a whole or to a significant increase to the recently-established bailout fund. What seems certain is that the terms of a Greek default must be negotiated and it is recognised that measures to strengthen the region's banks must be taken before this can occur. The recent failure of Dexia, which passed its financial stress test earlier in the year, highlights the need to shore up the banking system in advance of any debt restructuring. Equities in Europe excluding the UK fell 24% during the quarter compared to 14% for global equities as a whole. Brompton private clients are not currently invested in Europe ex-UK equity funds.

Recent market falls have been particularly severe in the emerging markets. Brompton clients' exposure to these markets was reduced earlier in the year in response to the relatively high valuations of many of these markets such as India and investment in the developed stockmarkets of US and Japan was increased. The lower debt levels and superior growth prospects of the emerging economies have not been sufficient to offset the rapid rise in risk aversion. Valuations in these economies

are now approaching more attractive levels and we will look for an opportunity to increase holdings again should they become oversold as the eurozone crisis plays out. In the face of near-term panic it is easy for investors to lose sight of the long-term structural changes taking place in the global economy. Concerns about a "hard landing" in China are mounting following the release of lower-than-expected third-quarter gross domestic product growth but the figure was still 9.0% and the long period of policy tightening in China appears to be coming to an end.

Finally, the death just after the quarter end of Steve Jobs, founder of Apple, drew many tributes from politicians and businessmen. In recent years, Apple can be said to have invented the smart phone and tablet computer categories, creating both wealth and jobs. Brompton clients are invested in the technology sector, where many of the entrepreneurs of the future will emerge. Global economic growth may remain weak overall for some time as the process of deleveraging continues in the developed world but there will be opportunities for investors prepared to look to the longer term.



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