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GVI comments on the recent downturn in world equity markets.
Roy Chen – Head of Investment GVI

January 24, 2008

International equity markets have had a tough year in 2007 and we can expect 2008 to be even more challenging, particularly in the first half of the year. These are not normal times for markets where the increased volatility and uncertainty will test even the most seasoned of fund managers.

As you would probably have read in our regular GVI Monthly Updates, we continue to adopt a cautious approach to markets and remain vigilant with what is happening within our portfolios. On a positive note, the recent downturn is presenting us with a range of investment opportunities and we are assessing these for possible inclusion in our portfolio.

(Please refer to the "GVI's current portfolio positioning" section below on our current strategy, as we move into 2008)

While value has reappeared caution is still prudent

Certainly, many stocks are cheaper today than they have been in recent times, but it doesn't mean they won't become even cheaper. Financial stocks for example, a sector in which we have been very underweight; many banks are looking very cheap but we believe a vast majority of them are a value trap for the unsuspecting investor who doesn't properly focus on the capital structure of their businesses and their ability to meet future commitments.

The deterioration in conditions facing the financials sector have become further complicated as monoline and bond insurers in the US have come under sustained pressure with AMBAC (one of the largest public finance insurers) being recently downgraded from AAA to AA. This has contributed to the large falls in Euro banks, as information about the banks' exposure to monolines is not readily available, creating further uncertainty. The stocks we hold in this sector (mainly European retail banks), while not immune to panic selling, are all well-capitalised and have strong retail/deposit franchises. Our research shows that banks held in our portfolio are predominantly supporting their own liquidity and without having to source funding externally from the wholesale market.

The situation facing the US Economy.

Clearly, there is a very real risk of the US falling into a recession (some would argue that it already has!) would have significant implications across all sectors worldwide (from consumer discretionary, energy, materials, financials and of course, to the IT sector). Tighter credit conditions induced by the sub-prime crisis have already impacted on profit growth for many businesses and have affected their earnings outlook over the medium term. In addition, the average consumer is very conscious of the fact that goods and services are starting to cost more as oil and commodity prices having already risen, remain stubbornly high, impacting everyday purchases. This situation becomes amplified when one considers that approximately 70% of US GDP is driven by consumer spending which, in turn, has been largely fuelled by unsustainable growth in the use of long-term debt to fund consumption (E.g. Home equity draw downs). As the housing crisis continues to have flow-on effects to the rest of the economy, with unemployment starting to rise, especially in property and credit related industries and slower retail sales being reported, this doesn't augur well for investment markets and the overall economy in the first half of this year at least.

As an indication of the seriousness of the problem, US Federal Reserve Chairman Ben Bernanke has supported the move by Congress to provide an emergency fiscal stimulus package to lower and middle income earners to stave off an impending recession. In an emergency-like reaction, Bernanke's recent 0.75% aggressive rate cut is a clear indication that the primary focus now is on re-inflating the economy and supporting financial markets in a similar fashion to his money-printing predecessor that coined the phrase "irrational exuberance" which incidentally, can also be used to describe lending and funding standards leading into this current financial turmoil. The number of write-downs by global banks and foreclosures on mortgages by homeowners over the last few months is testimony to that.

It is inevitable that in a panic-induced period of indiscriminate selling almost all long-only portfolios will be affected. The true test of a portfolio is the ability for it to bounce back from such a sell-down. In our experience, companies that have a demonstrable earnings profile, strong cash flow and little or no debt on the balance sheet and that reward shareholders with a healthy dividend while the market sorts itself out, tend to rebound and regain previous highs quicker than those who do not. It is from these types of defensive companies that investors seek to gain greater certainty and comfort in turbulent times such as these.

GVI's current portfolio positioning:

- Our higher cash weighting is a reflection of our outlook and the state of the market. We feel comfortable in positioning the portfolio to protect our clients' assets as much as we can under the current environment. Naturally, being a nimble boutique investment manager, we have the cash “ammunition” to deploy at times like this when we determine it is prudent to do so. Highly volatile conditions often present attractive entry points for investors to acquire quality businesses that in our view have been oversold.

- The portfolio remains skewed towards conservatively-run businesses that can continue to pay dividends even if times become more difficult. The GVI investment approach avoids heavily-geared businesses with aggressive growth plans that have the potential to be seriously affected by the double-whammy of higher funding costs and slowing economic growth which can have disastrous effects on already deteriorating profit margins.

- The Fund does not invest in speculative businesses, single commodity producers or businesses that are, in our view, expensive and cannot be supported by solid transparent earnings and cash flow.

- We expect our investments in typically defensive sectors such as Telecommunications, Utilities, Consumer Staples, and Healthcare to continue to assist the portfolio weather these volatile conditions and to provide a steadying influence on the portfolio.

It is still unclear as to whether the current turbulence in the market is going to be a sharp and short affair or a more protracted episode. Much hinges on the way the US manages its current situation and if they are able to avoid going into a deep recession. Also critical is the extent to which any further surprises from the financials sector can undermine profit margins and investor sentiment.

While we remain cautious, we are comfortable with the way our portfolio is positioned during this market correction and as value opportunities present themselves, we will selectively purchase shares in some of these companies where they meet our strict criteria as to business quality and valuation.

Kind regards,

Roy Chen
Head of Investments