Back to fundamentals - real investing and not momentum - Part 1

26 November 2008

One of the overriding concerns for investment markets today is the impact of the global economic slowdown on the future earnings of businesses. As an increasing number of economies officially declare that they are in recession (UK, the Euro zone and more recently Japan while the US is yet to officially declare), there is a heightened level of uncertainty which has dramatically reduced consumer, investor and business confidence to record lows. The level of volatility in financial markets in recent weeks has been extraordinary and has presented investors with extremely difficult conditions.

GVI Portfolio Positioning

Last week saw another difficult week as investment markets tested new lows. The GVI portfolio continues to maintain its cautious and defensive approach as it has done since early 2007. This is evidenced by our relatively low exposure to financials, reduced exposure to consumer discretionary stocks from 12% to 6% and our continued skew towards typically defensive sectors with more predictable earnings such as utilities, telcos, and healthcare. Despite this however, we have seen the portfolio suffer losses as equity markets capitulate in a historically spectacular fashion.

Volatility presents opportunities

The GVI investment team is continually testing the business case for each of our holdings with the aim of improving the overall quality of the portfolio under these difficult conditions. In addition, the market downturn has presented the investment team with some very interesting long-term opportunities which we are assessing during our formal daily and weekly meetings. While some stocks have fallen quite heavily in the recent sell off they still remain attractive to GVI on quality and valuation grounds.

GVI European exposure

Many of the European-based multinationals GVI invests in such as Nestle, Vodafone, Shell and Novartis possess very diverse businesses that operate in various geographical areas. This is particularly the case for energy, pharmaceuticals, food and telecommunications stocks. In addition, companies providing basic services such as our utility holdings (power generation, gas, heating and water operation) are less impacted by economic cycles of the global economy. Infrastructure assets need to be planned and built with a much longer time horizon and payoff. We continue to believe that our holdings in the energy, telecoms, industrial and utilities sectors are currently not being valued correctly by the market and have created very good buying opportunities.

GVI's largest sector weightings are Health Care, Utilities, Energy and Telecoms. We are more cautious on the following sectors: Materials, Discretionary, Industrials and Financials.

Analysis of recent 3rd quarter reported earnings

A majority of our stock holdings have reported their 3rd quarter earnings results. The recent results from one of our holdings BASF provides ample evidence (if the collapse of Ford and GM are not sufficient) of the significant and rapid decline in demand in key industries and the slowdown occurring in the US, Europe and globally. BASF, a German multi-national chemical manufacturing business, is idling a significant amount of production capacity world wide (~25%) in response to this massive decline in demand. It is downgrading its expectations for EBIT this year as a result and providing no guidance for 2009. Clearly, the operating environment is becoming increasingly difficult for companies worldwide as we are in the throes of a large downturn reflected in weak earnings momentum.

The GVI investment team has conducted a thorough analysis of the 3rd quarter earnings results with a keen focus on each company's:

- operating environment
- earnings
- dividend sustainability
- balance sheet strength

Below are a couple of the key observations.

Dividends for 08 sustainable

An important message to communicate is that, in a vast majority of cases, the dividend for 08 is sustainable and not at risk for shareholders. Almost all the companies in our portfolio that have reported so far have maintained their dividend commitments for 2008 and in at six cases (mostly healthcare), have increased them. We believe that a handful of stocks are likely to reduce their dividend payments due to rapid earnings declines (Daimler, Telecinco and Mitsui are cases in point) See below for a summary of our analysts' comments of the stocks so far reported.

High quality balance sheets

Another key observation is that the balance sheet strength of the stocks in the portfolio is generally of a high quality which provides us with a degree of comfort in the context of the ongoing credit crisis where funding is more expensive and difficult to obtain. Moreover, we believe that these conservatively-run companies with "lazy" balance sheets are better placed to position themselves favourably for the next phase of the business cycle, with potential value accretive acquisitions and/or prudent cap ex to improve organic growth and market share.

We expect 2009 to be a difficult year as recessionary conditions start to take hold. It is also a period where excellent long-term opportunities arise. We look forward to providing you further information in Part 2 of this communication later this week.

Kind regards,
GVI Investment team

Companies Earnings Highlights
Quarter 3, 2008

	OPERATING ENVIRONMENT	EARNINGS	DIVIDEND	BALANCE SHEET
CONSUMER STAPLES				
Nestle	Strong. Nine month sales increased 8.9% organic growth, 3.4% real internal growth.	Q3 sales up 2.5%, no EPS numbers for quarters	Annual dividend, no changes expected to the estimate.	Total debt to common equity is 58%, plus they are still going to sell Alcon to Novartis. No issues
HEALTH CARE				
Novartis	Challenging as always with an unknown regarding President-elect Obama. Novartis is still buying Alcon from Nestle	Full year sales guidance is on track. Q3 2008 sales were CHF 10747, up 11.8% over the last year. EPS was up 35.9% to CHF0.92 per share	Annual dividend, no changes expected to the estimate.	Total debt to common equity is 12%, and interest cover is 31x.
Pfizer	Challenging as always with an unknown regarding President-elect Obama. Still facing massive patent challenge in 2011 with Lipitor.	Adjusted EPS of $0.62 beat consensus estimates of $0.60. Revenue decreased by 1%. Narrower FY08 EPS guidance of $2.36 - $2.41 from $2.35-$2.45.	Quarterly dividend was stable, expected to rise in 2009	Total debt to common equity is 24%, and interest cover is 31x.
GSK	Challenging as always with an unknown regarding President-elect Obama.	EPS for Q3 2008 was 25.2 pence, which beat consensus of 24.1p. GSK raised its annual dividend . For the first 9 months of 2008 GSK bought GP 3 billion worth of its own shares.	Quarterly dps was up 7% from Q2	Total debt to common equity is 110%, and interest cover is 17x.
UTILITIES				
Verbund	Operating environment is favourable but lower power price trends are a negative although it has sold forward in various % for the next two years	Positive earnings trend and increasing cash flow, net income to grow >20%	No risk to dividend	No financing risk, low debt, Interest cover 7.6X and net debt/EBITDA of 1.7X
Fortum	Operating environment is favourable but lower power price trends are a negative although it has sold forward in various % for the next two years	Positive earnings trend and net income to grow >20%	No risk to dividend	No financing risk , low debt with interest cover of 9.8 X and net debt/EBITDA of 1.7X
RWE	General economic picture now significantly worse. German GDP expected to grow by 1.8%. EBITDA expected to match previous year (maintained target). Net income to increase by more than 10%	Revenue up 15% to €9.7bn. EBIT up 59% to €1.7bn. Ahead of consensus estimates. Strong result driven by power generation (+22%). 9m EBIT was up 5%	Annual dividend, no changes expected to the 70-80% payout this year (guided previously)	net debt to equity is 25% but taking away their assets held for sale (American Water) the company is net cash. Interest cover is 4.3x

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Companies Earnings Highlights *(cont'd)*
Quarter 3, 2008

	OPERATING ENVIRONMENT	EARNINGS	DIVIDEND	BALANCE SHEET
ENERGY				
Exxon	Despite lower oil price, Exxon continues to deliver good results across all divisions	3Q EPS above expectations and continues to generate strong free cash flow	Dividend definitely not at risk but Exxon always opt for more share buyback than dividend payment	Cash continues to pile up now with $36.7 billion in net cash on blance sheet
RD Shell	All divisions performing well	3Q EPS above expectations and continues to generate strong free cash flow	Dividend Yield of 5.5% can be maintained	Interest cover over 60X, very strong balance sheet
ENI	The production growth +6.3% yoy best in the sector, upstream segments strong offset by weaker Petrochem and gas &power	Strong adjusted net profit up 67% yoy	Dividend not at risk backed by strong cash flow but ENI wants to maintain high dividend , current DY=7.5%	Balance sheet is strong and the company wants to maintain low leverage targeting at no more than 0.40
TELECOMMUNICATION SERVICES				
KPN	Positive trends in all 3 countries -domestic operations stabilising and good growth remains in Germany	Q3 shows EPS likely to be up 15% for the year with company confirming targets for FCF, EBITDA and Rev	Confirming good dividend from the current level of >5%	Recent bond issue means solid liquidity position , net debt/EBITDA of 2.4X
TeliaSonera	Stabilising trends in mature Nordic markets. No negative news from emerging markets with Eurasia particularly strong	EPS shoould grow 6% in 2008	Dividend not at risk DY=5.7% well supported by DCF yield of >8%	Balance sheet very strong with net debt/EBITDA of just 1.2 X , Solid credit rating Moody A3
Vodafone	Top line growth is slowing but company is embarking on major cost-cutting drive	1H EPS up 15%, guided higher FCF despite lower revenue growth	Small increase in interim dividend and 7.5% dividend yield is secured	Balance sheet strong and no liquidity issue, interest cover >5.5 X
CONSUMER DISCRETIONARY				
Vivendi	Earnings are well underpinned by non-cyclical business the bulk of its earnings are subscription-based	Q3 headline net income declined but company re-iterated 2008 net income to increase 8% excluding acquisition impact	Expect dividend to increase 8% in line with net income	No liquidity issue with strengthening balance sheet , interest cover >10 times
Daimler	Challenging outlook facing industry globally	Based on Q3 results we can expect earnings to decline for 2008	We believe a small cut in dividend is possible	Strong net cash position
MATERIALS				
Fuchs Petrolub	Company expects more challenging 4Q but falling oil price should help as well	2008 should grow at about 4.4%	The current dividend yield of 5.2% is well supported by its high FCF yield	Company is nearly in net cash now with interest cover of over 23X
INDUSTRIALS				
Singapore Airlines	Industry is getting more challenging	Expect earnings to dive this year and also likely to see margins to trough	Despite earnings to decline, current dividend is sustainable which will put the stock at a yield of over 8% to lend support to the stock	Net cash balance sheet