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Sovereign Risk; our take – 25th May, 2010

We perceive sentiment has moved to the point it is giving western governments a mandate to start structural debt reduction programs. There are early signs of this process gaining traction; at the very least the days of the "pork barrelling re - election cycle" should be behind us.

The concept of debt reduction is simple, its actual implementation though will be more difficult. Governments only have a handful of direct levers to reduce debt and none of them are that palatable. They can spend less, tax more, sell assets or print money. The best outcome we can hope for is a broad based increase in economic activity. That is, businesses grow, employment grows, GDP expands and government debts start to peak and then reduce through their share of the increased activity. While, this scenario is the ideal, we suspect the reduction processes will at a minimum also be augmented with a combination of the direct levers described above.

Given this backdrop; themes that will flow through to the fund are:

1) Tax minimisation and aggressive structuring is out and likely a liability going forward. Corporates need to be paying their fair share.

2) Good businesses with genuine franchise characteristics and natural advantages should be supported, given every opportunity to grow and incentivised to reinvest. The multiplier effects from these businesses are vital to economic growth.

3) When we come across what we consider to be a very good business in a country where both the capital markets and currency are being aggressively discounted due to sovereign concerns we are going to take a close look at it as a prospective investment. If we are confident the business won't get nationalised and that the countries fiscal position isn't beyond repair we feel this combination of a high quality business, cheap asset price and discounted currency potentially gives us an attractive investment.

4) If we view a sovereign's situation has progressed to the point it is beyond repair, and this view is not commonly held, we will look to gain exposure to this deterioration if it is economic to do so.

Sovereign risk has clearly become a central focus for the media and investment commentators. Our view is the issues are reasonably transparent, the current mainstream attention provides a mandate for change and with change generally the issues will steadily be addressed. As the fear and volatility sweeps through individual markets we will spend a bit of time isolating the issues and making an assessment if the immediate focus on sovereign risk is creating a genuine opportunity for longer term investment.

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