

OLDFIELD PARTNERS LLP

NEWSLETTER Q1 2007

This quarterly newsletter is the companion to our monthly reports on clients' portfolios and the pooled funds which we manage.

In addition to the global equity portfolios which constitute most of the firm's assets under management, we manage also a European fund and a special situations fund (Eccleston Special Situations Fund), and also a fund-of-funds. Overstone Fund plc includes the following:

	<u>Start date</u>	<u>Assets</u>
Overstone Global Equity Fund	June, 2005	\$459m
Overstone European Equity Fund	October, 2005	\$21m
Overstone Opportunity Multi Fund	November, 2005	\$33m

The Eccleston Special Situations Fund is a sub-fund of a Jersey-based OEIC, and is currently US\$13 million in size. In addition we advise two pooled funds, with assets of \$128 million, for US taxable investors, and we manage a number of separate portfolios.

We produce monthly newsletters for each of the pooled funds. If you do not currently receive a newsletter for any of these but want to in the future, please email info@oldfieldpartners.com.

Our approach in the management of global equity portfolios, managed by Richard Oldfield, is long-only, no leverage, value-focused, large-cap, index-ignorant, highly concentrated, and anti-short-term. The portfolio has never had more than 22 holdings, currently 19. There is little ex ante decision-making about the attractions of particular countries. With rare exceptions the country weightings are the result of stock selection. The largest holdings include ConocoPhillips, ABN Amro and Hitachi.

The European fund, managed by Claus Anthon, has much the same features and philosophy, except that it digs deeper in terms of company size, and generally has a bias towards under-researched markets such as those in Scandinavia. Current holdings include; Kone, the Finnish lift and escalator manufacturer and Royal Caribbean Cruises, listed in Norway. The fund has 20 holdings.

Eccleston Special Situations Fund, managed by Nigel Waller, focuses mainly on interesting and undervalued small and mid-sized companies as well as on larger companies where for some reason the situation does indeed appear special. The approach is, as with the other funds at Oldfield Partners, concentrated and index ignorant, with the usual emphasis on cash flow and value. Holdings include Natuzzi and KAS Bank among small companies and Microsoft and France Telecom among large ones. The fund has 22 holdings of which 15 are below \$5bn in market capitalisation.

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Overstone Opportunity Multi Fund (“OOMF”) is a fund of funds, aiming at return without much concern with volatility, and focused eclectically on a few (6-18) funds with managers who have a philosophy similar to our own (value-focused, index-ignorant, highly concentrated), but who are operating in areas some of which are much too specialized for us to be investing in directly – for example, Taiwan, the water industry, gold shares.

Oldfield Partners has a total of \$2 billion under management for families, individuals, charities, trusts, endowment funds and pension funds, either through separate portfolios or through pooled funds. The executive partners are Claus Anthon, Jamie Carter, Richard Oldfield, and Nigel Waller.

Performance Summary as at 31st March 2007

Global Equity

US\$ terms	Global Equity Composite ¹	MSCI World (NDR)
Q1 2007	+1.8%	+2.5%
2006	+22.0%	+20.1%
Since 11/03/05	+34.9%	+32.9%
Since inception *	+297.3%	+114.1%
Since inception per annum *	+14.4%	+7.7%

¹ The performance shown is of a composite of all US dollar denominated global equity portfolios managed by Richard Oldfield at Alta Advisers from 1997 to 11th March 2005 and at Oldfield Partners since 14th March 2005. Before 2000 the performance of two portfolios is excluded from the composite because their returns were inflated by the inclusion, in those portfolios only, of an unquoted investment which, following its flotation, had a large favourable impact on returns. Performance is calculated on a total return basis and is net of investment management fees and expenses. Before 11th March 2005 fees were substantially lower, in broad terms close to 1% less, than those charged by Oldfield Partners.

* Inception 1 Jan 1997. Source of data: Alta Advisers Ltd, Pictet, Oldfield Partners LLP, MSCI © and Bloomberg.

US\$ terms	Overstone Global Equity Fund ²	MSCI World (NDR)
Q1 2007	+2.0%	+2.5%
2006	+21.4%	+20.1%
Since inception *	+38.8%	+36.9%

² The performance shown is that of the 'A' shares in the Overstone Global Equity Fund and is calculated on a total return basis, net of all fees and expenses.

* Inception 1 June 2005. Source of data: Oldfield Partners LLP, MSCI ©, Bloomberg and Northern Trust Intl Fund Administration Services (Ireland).

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European Equity

Euro terms	Overstone European Equity Fund 3	MSCI Europe (NDR)
Q1 2007	+5.7%	+2.4%
2006	+22.7%	+20.0%
Since inception *	+32.3%	+27.4%

3 The performance shown is that of the 'A' shares in the Overstone European Equity Fund and is calculated on a total return basis, net of all fees and expenses.

* Inception 3 October 2005. Source of data: Oldfield Partners LLP, MSCI ©, Bloomberg and Northern Trust Intl Fund Administration Services (Ireland).

Fund of Funds

US\$ terms	Overstone Opportunity Multi Fund 4	MSCI World (NDR)
Q1 2007	+1.0%	+1.8%
2006	+19.1%	+20.1%
Since inception *	+39.8%	+30.0%

4 The performance shown is an **estimate** of the performance of the Overstone Opportunity Multi Fund, using provisional prices of the underlying funds as at 30 March 2007. Performance is calculated on a total return basis, net of all fees and expenses.

* Inception 1 November 2005. Source of data: Oldfield Partners LLP, MSCI ©, Bloomberg and Northern Trust Intl Fund Administration Services (Ireland).

Special Situations

GBP terms	Eccleston Special Situations Fund	MSCI World (NDR)
Q1 2007	+5.1%	+1.9%
2006	+22.3%	+5.5%
Since 14/3/2005 *	+46.5%	+30.1%

* the date that Nigel Waller became manager of the fund following the current investment strategy.

Source of data: Oldfield Partners LLP, MSCI ©, Bloomberg and Rawlinson & Hunter (Jersey). Performance is calculated on a total return basis, net of all fees and expenses.

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Commentary

“Unstable, unbalanced, uncoordinated and unsustainable” is how the Chinese premier, Wen Jiabao, described Chinese macro-economic conditions. The Governor of the Reserve Bank of India, raising interest rates, said that “to contain inflation without unduly impacting the growth momentum is not only an economic necessity but a moral compulsion.” This is pretty strong stuff.

Meanwhile, for rosier-tinted official commentary, turn to the International Monetary Fund. Its latest forecast is for the world economy to grow by 4.9% in real terms this year, while the US economy grows by 2.2%. In the optimism of forecasters about the world economy and relative caution about that of the US there has been a worrying reliance on countries like China and India to continue to provide all the fizz; and now there is the paradox that the authorities in both these countries are trying to take away some of the fizz.

Another recent official utterance has been equally blunt, on a different, and narrower, subject: the US Chemical Safety Board, in its report on the explosions at one of BP’s refineries, said: “the prevailing culture at the Texas City refinery was to accept cost reductions without challenge and not to raise concerns when operating integrity was compromised. Cost cutting in the 1990’s left the refinery vulnerable to a catastrophe”.

In future one can imagine an exchange between a big multinational’s headquarters and one of its manufacturing or producing divisions going something like this:

HQ: “Please cut your costs by 5% in the coming year.”

Manufacturing or producing division: “We are not sure we can do this without compromising safety.”

HQ: “Oh. Better not, in that case.”

The Chinese and Indian policy intentions point to the risk of economic slowdown; the Chemical Safety Board report to the possibility of a reduction in profit margins. Labour costs as a proportion of GDP have fallen fairly steadily for more than twenty years. With the prospect of a Democrat president in two years time as well as a Democrat majority in both houses of Congress, it is not a good time to bet on that trend continuing. There are other cost pressures, raw materials among them.

In spite of these thoroughly good reasons for mounting concern, we remain optimistic about stock markets because we see little prospect of any serious increase in interest rates in the major markets, and above all valuations are still moderate. The Standard and Poor’s average price earnings ratio is around 15, which is close to the long term historic average. The price earnings ratio in European markets is lower, around 13. It is true that profit margins are probably unsustainably high. But even if net income grows a little less rapidly than revenues, growth in earnings per share could still keep up with that of revenues because of companies buying back their own

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shares. During 2006, as a result of mergers and acquisitions, buybacks, and leveraged buyouts, there was “de-equitisation” in the US to the tune of 5%. Companies remain cash rich, and there is no reason why 2007 should not look much like 2006 in terms of de-equitisation.

The major threat to markets would come from a significant rise in inflation and, consequently, sharp rises in interest rates. There are reasons at least not to be completely dismissive about this. The rate of inflation in the UK is 3.1% in terms of the consumer price index but 4.8% in terms of the retail price index which used to be the general standard for measuring inflation. In the US, the picture is mixed, but the cautiously expressed overall verdict of the chairman of the Fed is that “there are some indications that inflationary pressures are beginning to diminish”.

So we remain nervously optimistic, with the emphasis some days more on the nerves and some more on the optimism. Our portfolios – Global, and in Europe and the Special Situations fund – are as usual based very much on the selection of individual companies which appear to us undervalued, and there are plenty of these about.

Several of these companies in the global portfolios are large “quality growth” companies, with strong cash flow, high return on equity, good balance sheets, and historically good growth rates. Small companies have hugely outperformed large companies over the last several years. The reasons for this are not altogether clear, and it seems just to be part of the cyclicity of market behaviour. In the mid 1980’s, it was accepted wisdom that small companies always outperformed – more agile, more focussed, less bureaucratic, more able to multiply their revenues quickly. They then performed less well than big companies for a decade. By the end of the 1990’s, it had become conventional wisdom that large global companies would always have the upper hand: economies of scale, benefits of globalisation, tremendously valuable franchises and brand names. Large companies have then underperformed for the next 9 years. We are due for a reversal of this trend.

The largest fifty companies in Europe are selling at 12 times estimated 2007 earnings, compared with 25 times in 2000. The top 10 companies (by market capitalisation) in the UK are also at 12 times earnings, compared with 20 times for the other 90 in the FTSE 100 Share Index.

One explanation for the way in which large companies have, at least relatively, languished, is that they are not a suitable prey for private equity or trade acquirers. This may be true but there is an irony in that these large companies, often tremendously cash-rich and cash-generating, are themselves possible acquirers of smaller companies, just as private equity firms are. The market seems prepared to trust that private equity firms will be able to acquire companies and do well out of them, but not to trust big companies to do the same. This implies that private equity operators are immensely skilled and the managers of large companies immensely unskilled. This is too simplistic. Large quoted companies are probably no more or less likely than private equity firms to make acquisitions which help or hinder: if either buys a lemon, it remains a lemon. Just as a rose by any other name would smell as sweet, so a lemon in any buyer’s mouth is still as sour. The gap between the confidence of the market in private equity firms and the confidence in large industrial

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companies is probably unjustified; and so too is the gap in valuations of large companies compared with smaller companies.

Japan, where we have five stocks representing more than a quarter of global portfolios, has continued to be a drag on performance. The economy splutters along unconvincingly (although in the last quarter of 2006 the rate of growth was 5.5%). If not entirely non-plussed by what is happening, we are far from plussed. We feel that a great deal is going to plan. For the first time in 16 years the nationwide average of land prices was higher than a year earlier. In the major cities, land and property prices are unequivocally strong, in central Tokyo booming. The consumer is the weak link. The renowned Japan guru Brian Reading suggested in a fascinating letter to the *Financial Times* that what the Japanese should do is put their interest rates up from ½% to 3½%. There is an economic theory that in certain conditions a rise in interest rates stimulates consumer activity for semi-psychological reasons (just as on the whole we feel better when told how well we look), but this is not Brian Reading's reasoning, which is purely arithmetic: he says that, given the interest rate which consumers are receiving on their assets and paying on their liabilities, and the fact they have so much more of the former than the latter, a 2% rise in GDP would be the direct impact of the rise in interest rates he suggests.

Be that as it may, as Miss Marple would say, we remain confident that Japan is still, rather meanderingly, on the right track, and that in due course the consumer will respond to strength elsewhere in the economy. The long delay reflects just the depth of the awfulness of the fourteen or so years from 1990. In the corporate world, the increase in western-style activism, mergers, share buybacks, dividend increases, purchases of quoted minority stakes by their parents, and spin-offs is encouraging. The recovery, both economic and stock market, which began in 2003 is no longer in its infancy, and it is bumpy; but we feel we are still in the first half of the game.

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