

OLDFIELD PARTNERS LLP

NEWSLETTER Q4 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 equity fund, an all cap global equity fund a Japanese equity 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	\$746m
Overstone European Equity Fund	October, 2005	\$37m
Overstone Opportunity Multi Fund	November, 2005	\$40m
Overstone Japanese Equity Fund	October, 2007	\$3m
Overstone All Cap Equity Fund	October, 2007	\$2m

In addition we advise two pooled funds, with assets of \$140 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 and currently has 22. 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 Barrick Gold, Microsoft 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, Storebrand, Sandvik and Siemens. The fund has 23 holdings.

Overstone All Cap Equity Fund, managed by Nigel Waller, invests globally across the market cap spectrum but focuses mainly on interesting and undervalued small and mid-sized companies. 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, KAS Bank and M&C Saatchi. The fund has 21 holdings.

Overstone Japanese Equity Fund, managed by Robert White, invests exclusively in Japanese equities. The fund is index ignorant in its sector allocation and seeks to outperform the TOPIX benchmark combining partially a thematic approach and partially the identification of significantly undervalued assets. There are currently 25 holdings, the maximum targeted level, predominantly in medium and large stocks with a capitalization above US\$1 billion, these include Daiwa House, Shinetsu Chemical and Tsuruha Holdings.

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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 \$2.3 billion under management from 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, Nigel Waller and Robert White.

Performance Summary as at 31st Dcember 2007

Global Equity

US\$ terms	Global Equity Composite ¹	MSCI World (NDR)
Q4 2007	0.0%	-2.4%
2007	+6.8%	+9.0%
2006	+22.0%	+20.1%
Since inception *	+132.5%	+26.6%
Since inception per annum *	+11.1%	+3.0%

¹ The performance shown is of a composite of global equity portfolios. Performance is calculated on a total return basis, net of all fees and expenses. A full GIPS® compliant presentation of the global equity composite performance is available from Oldfield Partners.

* Inception 1 Jan 2000. Source of data: Alta Advisers Ltd, Pictet, Oldfield Partners LLP, MSCI © and Bloomberg.

US\$ terms	Overstone Global Equity Fund ²	MSCI World (NDR)
Q4 2007	+0.1%	-2.4%
2007	+8.0%	+9.0%
2006	+21.4%	+20.1%
Since inception *	+46.8%	+45.6%

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)
Q4 2007	-7.1%	-2.8%
2007	+10.9%	+3.0%
2006	+22.7%	+20.0%
Since inception *	+38.8%	+28.0%

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).

All Cap Equity

US\$ terms	All Cap Equity Composite ⁴	MSCI World (NDR)
Q4 2007	-7.0%	-2.4%
2007	+0.7%	+9.0%
2006	+39.2%	+20.1%
Since Inception *	+47.0%	+44.9%

⁴ The performance shown is of a composite of all cap global equity portfolios. Performance is calculated on a total return basis, net of all fees and expenses. A full GIPS® compliant presentation of the all cap equity composite performance is available from Oldfield Partners

* Inception 1st April 2005. Source of data: Oldfield Partners LLP, MSCI ©, Bloomberg and Rawlinson & Hunter (Jersey) and Northern Trust Intl Fund Administration Services (Ireland).

Japanese Equity

US\$ terms	Overstone Japanese Equity Fund ⁵	Topix (NDR)
Q4 2007	-4.8%	-7.1%
Since Inception *	-4.8%	-7.1%

⁵ The performance shown is that of the 'A' shares in the Overstone Japanese Equity Fund and is calculated on a total return basis, net of all fees and expenses.

* Inception 1st October 2007. Source of data: Oldfield Partners LLP, MSCI ©, Bloomberg and Northern Trust Intl Fund Administration Services (Ireland).

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Fund of Funds

US\$ terms	Overstone Opportunity Multi Fund 6	MSCI World (NDR)
Q4 2007	-3.0%	-2.4%
2007	+11.9%	+9.0%
2006	+19.2%	+20.1%
Since inception *	+50.1%	+38.3%

⁶ The performance shown is an **estimate** of the performance of the Overstone Opportunity Multi Fund, using provisional prices of the underlying funds as at 31 December 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).

Commentary

According to a psychologist at the University of Cardiff, 24th January is usually the worst day of the year, more people feeling depressed on that day than on any other. We think that the present ghastliness of markets is providing opportunities for investments which, over the next couple of years, are likely to give excellent returns.

“Are you always optimistic?”, someone asked us recently. The answer is no. Examples can be provided. But we do have a tendency to optimism, with a Whiggish view of economic progress and in the long run of the after-inflation returns which equities tend to give, with the occasional painful bash on the head. This particular bash is severe. But betting against that trend is therefore betting against the odds, sometimes right but not generally for long.

There have of course been quite long periods, decades in some cases, where economies have stagnated and equities have been no good: the global depression in the 1930s, Japan in the 1990s. Those who spotted these periods in advance, or at least not too long before they had started, did well to do so. Some people think that something like this is what we now face, in the Anglo-Saxon world especially. If that is right prospects are bleak. If, however, the economic cycle is more ordinary, it might be a great mistake to run away from equities. The difficulty is naturally that it is very hard to tell.

Part of our tendency to optimism arises from the simpler realism that prediction is a mug's game. We annually recount the story of Kenneth Arrow, Nobel Prize winning economist, who, employed as a meteorologist in the US Air Force in World War Two, asked to be relieved of his responsibility for making medium term weather forecasts because he realised that his forecasts were no more than randomly right. The answer came back: “the Commanding General is well aware that your forecasts are no good. However, he needs them for planning purposes.”

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The fallibility of the most expert forecasts struck us recently in noting that the Philadelphia Federal Reserve Board survey of economic outlook had recorded its lowest reading since the aftermath of 9/11. That date is interesting because in fact the recession of that time ended only two months after 9/11. There was plenty of reason after 9/11 to be very gloomy about economic prospects, just as there is now, and most people were, just as they are now. But it turned out differently.

The current readings are very poor. US consumer spending is finally under pressure, with retail spending weak. Housing starts are only just over a million, annualised, and the inventory of unsold new houses is now equivalent to over nine months of sales. A recession may well have started, in the US and the UK, at the end of last year. But for all we know it could be over within a few months. And since the mood of the markets is currently so gloomy, they may already be encapsulating the worst expectations, so that any relief from gloom would come as a nice surprise.

The argument against this rather sanguine, some would say complacent, attitude is that profit margins are close to all time highs and, if there is economic weakness, are likely to fall, possibly quite dramatically. A fall in profits is not usually a good background for markets, and lower profit levels would reveal that the apparently low valuations, in terms of price-earnings multiples, were built on sand. We suggest that many valuations are so low that only if there really were a dramatic collapse in earnings, about the predicting of which we are doubtful, is the valuation argument for them undermined.

This is all quite different from 1999/2000, when the price-earnings ratio of US and European equities was in the 40s. It is not as if there has been a terrific bubble in western equity markets since the turn of the century. In the 8 years since January 2000 to the end of 2007 the average annual return of the S&P has been 1.7%, the worst since the 1930s. To match the return of the second poorest decade, the 1970s, the S&P would have to go up by 54% before 2010. The gap between the earnings yield (earnings divided by price) of US equities and the yield of US Treasury bonds has therefore become wider than at any time since 1983.

It is hard to deny the violence of the current gloom. A small example of this was in the reaction to Marks & Spencer's sales figures recently. Foreshadowed by the management three days earlier, they were greeted, when announced, by a 20% fall in the M&S share price. When gloom is so extreme it is probably overdone. More broadly, one of the measures of investor sentiment in the US, the AAI index, is at its lowest level (in the ratio of bulls to bears) since late 1990. January 1991 would have been an even better time to be a buyer of US equities than October 1990, but for all but those with the shortest of outlooks October 1990 did quite nicely.

In times of general gloom, people build up liquidity. This is what we have found among those to whom we talk. Many families and institutions have unusual amounts of cash. Markets do not need to rely wholly on the munificence of the sovereign wealth funds.

The origins of the gloom are, it seems, twofold. First, there continues to be enormous uncertainty about the scale of problems in the financial system, with the viability of the monoline insurers and the reliability of credit default swaps now in jeopardy. Second,

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weakness in the housing market in the US and elsewhere, which was the cause of the credit crunch, and the credit crunch itself are causing concern that recession has already started or is about to start.

As to the first of these, the problem is not just in the scale of the disaster but the difficulty in determining just how big a disaster it is. One commentator has written “the magnitude of the unknowns is such that we cannot hope to know true values.” This is hard to disagree with, but the point we would make is that such uncertainty seems likely to produce an inefficiency in markets and hence an opportunity. All around the world investment teams discuss the companies most affected by the crisis. The financial analyst talks about HSBC, or UBS, or Citigroup, or RBS. The head of the team concludes: “we do not know enough about this. Get rid of it. We cannot hold it if we do not know.” The result, it seems to us, is very likely to be excessive avoidance action. Many financial stocks now look to us appealing. There is a great deal we do not and

cannot yet know. But their valuations already suggest that the birds have flown. Moreover, some of the huge write-downs that have taken place may well turn out to have been over-cautious and to lead to write-backs of profits over the next several years. As John Thain of Merrill Lynch said as he announced Merrill’s latest shockers, these write-downs are “extremely conservative”.

The second concern, about recession, appears, as widely held views always do, thoroughly well justified. Samuel Brittan, while not disputing or even debating whether recession was upon us, wrote in the *Financial Times* a rejoinder to the equally commonly held view that there was not much governments or central banks could do about it. He said this view was “profoundly wrong.” The level of interest rates in the western world leaves plenty of room for reductions. Mr Bernanke has talked about taking “substantive additional action” in a decisive and timely manner”. The use of “timely” may be a deliberate echo of Larry Summers’ call for fiscal measures which are “timely, targeted, and temporary”. Some have questioned whether Congress can get itself together sufficiently to introduce such measures. This is to underrate the pragmatism which US politicians and policy-makers usually show when their backs are against the wall, the sort of pragmatism manifested by Hank Paulson. Like Goldman Sachs, the Treasury can be expected not to give up easily. The level of budget deficit is low enough to allow steps to be taken without being ruinous to the US public finances. Some steps may be fairly general – a stimulus to the economy. Others may be specific, in relation to mortgage foreclosures or monocline insurers.

In Europe, pragmatism may have more trouble winning out. The European Central Bank is more wary of inflation than of recession. President Sarkozy’s suggestion of a summit at which the politicians might put a bit of pressure on the central bankers was stamped on firmly by Chancellor Merkel.

One other current market and economic phenomenon deserves comment and that is the notion of decoupling. In the last year or two it has become more and more commonplace for commentators to suggest that economic growth in Asia and other emerging economies is so well entrenched that it can continue untarnished by a slowdown or even a recession in the US. Perhaps it can, but we think it is worth

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remembering that the BRICs – Brazil, Russia, India and China – still constitute only 17% of world GDP, while the US accounts for more than a third. Earlier this year we heard Larry Summers, former Treasury Secretary and chief lobbyist for the fiscal push which the US now appears likely to get, describe emerging markets as the Standard & Poor's index (for US equities) with a beta of 2.5: in other words, whatever the US market did, up or down, the emerging markets could be expected to do two and a half times as much. That has been far from the case in the last six months during which the developed markets have stuttered and stopped while emerging markets have been very strong; but it might be more so in coming months. Last week the Chinese company Yue Yuen, which supplies Nike and Reebok with their shoes, reported disappointing figures and the share price fell 7%. This might be a harbinger of a phase in which the idea of decoupling loses credibility. The valuations of emerging markets do not give the comfort they gave five or three years ago.

But many other valuations give lots of comfort. Japan stands out. The average price-earnings ratio is at its lowest for thirty years. The stock market dividend yield is higher than the yield from Japanese government bonds. One broker has found 173 companies in Japan which are trading at market capitalisations less than the value of the cash they have on their balance sheets. Half the companies on the stock exchange are trading at a price below their book value.

This looks to us like a time to be brave. The uncertainties are such that we will only be half brave. We already have shares in the portfolio which are at tremendously attractive valuations, and we may have a few more of these; but a touch of moderation makes us reluctant to throw out companies like Vivendi, Johnson & Johnson and IBM, Steady Eddys with perfectly presentable valuations and a tendency to confound their sceptics by the production of continued growth.

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