

## **FOREIGN & COLONIAL INVESTMENT TRUST PLC**

**AGM 5 MAY 2011**

### **FUND MANAGER'S PRESENTATION**

**When we met here a year ago it was the day of the general election and I began by saying that I did not think that the election would have much impact on Foreign & Colonial. Looking back over the last year I think that was the right judgement, but what struck me most in reading the transcript of the meeting was that nobody mentioned the Gulf of Mexico disaster even though it had happened more than a fortnight earlier and was the biggest single corporate event of the year.**

**Despite BP's share price more than halving and its dividend being suspended Foreign & Colonial's own share price and earnings both rose in 2010, demonstrating yet again the resilience and robustness of our highly diversified portfolio. Your dividend was increased for the fortieth consecutive year and we are one of only seven investment trusts to have achieved four decades of rising dividends.**

**The chairman has told you the headline performance so far this year but let me give you more detail.**

**Starting with the bad news, the biggest negative influences on our performance this year have been Caithness Petroleum and the Japanese earthquake.**

**Caithness is an unlisted oil exploration company with extensive interests in Morocco. We first bought shares in 2007 and then we provided further finance in 2009 at a higher price. At the end of 2010 we valued our shares at the same price as when we last invested into the company in 2009 as we were optimistic Caithness would go public this year. It was then our ninth largest investment. The fighting in Libya means that nobody is going to buy a new issue whose main asset is in North Africa so the short term prospects for Caithness have clearly deteriorated. Therefore at the end of March we decided to write down our investment from £34m to £19m and it has dropped out of the top twenty holdings. We will review the valuation again formally at the end of June.**

**The Japanese earthquake, tsunami and nuclear reactor disaster are a devastating blow for the country and its people. It is still too soon to assess all the ramifications but there was an immediate negative impact on our Japanese portfolio. This fell almost 10% in March, due in large part to the collapse in the share price of Tokyo Electric Power, the operator of the Fukushima reactor and one of our largest holdings, which fell 75%. Japan now accounts for just 4.1% of our assets.**

I can't remember a year when two non financial events – a political revolution and a natural disaster – have had such a big impact. After several years of financial events dominating the news and affecting our performance it is a significant change.

In the rest of the portfolio Europe has been the best performer so far this year followed by North America while emerging markets have lagged.

The biggest positive influence on our results has been our private equity portfolio.

Our investment in private equity is the most distinctive feature of Foreign & Colonial and recent progress has been very encouraging for two reasons.

Firstly, the valuations at which we hold our private equity funds have gone up substantially this year. At 31 December we valued all these funds at a sterling value of £382m based on the best information we had at the time. We have now received formal valuations from all of our sixteen funds as at 31 December which in total are 7.9% higher than the values we used at the year end. These have been included in our end April figures and have added 4.9 pence to net asset value per share after cash flows and exchange rate changes. The increases reflect generally good trading by the ten thousand plus companies in the portfolio in 2010 as well as the rise in stockmarkets in the second half of the year. It takes about six to nine months for these underlying trends to feed through into our own net asset value so we are optimistic about further valuation increases.

The second and more important encouraging trend has been the sharp acceleration in the rate of cash realisations from the portfolio. In the four months to the end of April we have had cash distributions of £22.6m compared with £24.9m in the whole of last year. The reason this is so important is that the real measure of success in private equity is when an investment is realised and cash is returned. By the end of this year we expect a steady stream of net cash distributions. These will move us from the current weighting in private equity of 17% back towards our target figure of 10%.

One effect of cash coming back from private equity will be to improve our income position as the private equity funds produce all their returns in capital. This should add to an already improving situation. I mentioned earlier BP's dividend suspension, which cost us £2.5m last year. The dividend has been restored though at a much lower level and should add £1.5m to our income in 2011. Dividend growth from the rest of the portfolio is strong and there have been almost no cuts in dividends for the first time since 2006 so we are optimistic earnings per share will rise this year.

We will still need to draw on our revenue reserve to meet the Board's forecast of at least maintaining the dividend in 2011 but this reserve is more than twice the cost of the annual dividend. Cash distributions from private equity and the repayment of our debenture, on which we are paying eleven and a quarter per cent interest, in one thousand three hundred and thirty seven days will greatly help our income position so the position is very manageable.

We are very aware how important dividends are for shareholders and we are also very aware of our forty year record of increasing dividends. Many investors, though not Foreign & Colonial shareholders, underestimate the importance of dividends and dividend growth in absolute terms and as a protection against inflation. Since 1970 retail prices have risen thirteen fold and house prices thirty six fold but your dividend has gone up almost sixty four times.

Share buybacks are very much in the news. Many shareholders are concerned that buying back shares shows a lack of investment skill in finding good companies to invest in and others worry Foreign & Colonial will shrink steadily into oblivion. And surely if performance was better there would be no need to buy back any shares at all?

I think share buybacks are a fact of life in the investment trust sector and there is no major trust that has not bought back some shares since it became possible twelve years ago. Foreign & Colonial tried different buyback policies from 1999 to 2005 with limited success but in November 2005 we adopted our current policy of buying back shares at a 10% discount.

This has been an unqualified success. In the five years to the end of 2010 total assets fell by £102m but the share price rose 51 pence. It is hard to see how this has been anything but good news for shareholders. Buying our existing portfolio at a 10% discount is not quite a licence to print money but it comes pretty close.

We have projected forward to see what would happen if we carried on buying back shares at the rate of 5% per annum and stockmarkets were unchanged for the next ten years – a fairly cautious forecast I think you will agree. At the end of 2020 total assets would be £1,350m but the share price would be up almost 20% at 370 pence. Foreign & Colonial would still be one of the largest investment trusts. Even if we extrapolate out much further we will still be around. I am 51 and my employer expects me to die when I am 90. On the same trends Foreign & Colonial would still have assets of over £339m; and the share price would be 433p. I will not be making a presentation but I look forward to seeing many of you at the AGM in 2050.

I don't think we will buy back that many shares. Foreign & Colonial already has a very high level of individual ownership and new products like the Junior ISA for children should be great opportunities for us,

particularly as there is more and more concern about costs like university tuition fees. £3,000 per annum invested in Foreign & Colonial in the eighteen years to 28 February 2011 would now be worth £108,000 according to Morningstar, more than enough for tuition fees, a gap year and a deposit for a flat.

One important and often overlooked reason for this performance is our relatively low level of costs. The industry measurement of this is called the Total Expense Ratio or TER. Our TER has been around 0.5% of total assets for the last decade and the change in the management fee from the start of 2011 should mean it stays at that level for the next five years.

Let me conclude by talking about the outlook.

As always there are lots of things to worry about.

It is hard to see how calm is going to return to the Middle East and North Africa so the oil price is likely to remain high for the foreseeable future, even more so now because the greater use of nuclear power is off the agenda in many countries.

Unlike the 1970s when high oil prices were associated with rising inflation there is more concern now that they will have a deflationary impact by squeezing out other spending. In the 1970s central banks were very slow to increase interest rates and inflation took hold requiring much higher rates later to bring it under control. Despite all the worries about deflation I think inflation is much more likely and central banks will be slow to increase rates, just as they were in the 1970s.

The debts incurred in the private sector before 2007 and in the public sector thereafter have not gone away and it is difficult to see how they will be resolved. The problems of the Eurozone are not getting any better. A year ago ten year Greek bonds yielded 8.5% and now they yield 15.0% while Irish yields have gone from 5.4% to 10%.

Finally the regulatory response to the global financial crisis is proving to be cumbersome, confused and costly. My best guess is that the tide of greater regulation in all parts of finance will be running for the rest of this decade.

That is no different from the past – it was four years after the crash of 1929 before the US Securities and Exchange Commission was set up to regulate Wall Street. Indeed sometimes one event can lead to others in unexpected ways. It was the last major Japanese earthquake in 1995 that magnified Nick Leeson's losses and precipitated the collapse of Barings. It was the collapse of Barings that made the position of all the other traditional merchant banks untenable and led to their sales. Almost the last to be sold was Robert Fleming in 2000. We made almost

**£200m from that sale, though we had had to wait since 1943 when we originally bought the shares.**

**Last year I said that we had probably seen the best of the outperformance of emerging markets and I still think that is the case.**

**Many of these countries are suffering from increasing inflationary pressures from rising oil and commodity prices. They need to wean themselves off an export driven model to get more growth from domestic consumption. This is easy to say but much more difficult to do. Nowhere is this dilemma more acute than in China and the likelihood of a hard landing for the Chinese economy must be increasing. This was a major factor in our decision to wind down our Developed Asia portfolio at the beginning of this year.**

**Although I am worried about some of the economic and market prospects I do not think they will have much bearing on the growth prospects of individual companies in our portfolio which are supplying goods and services to emerging market consumers. None of these companies are highly valued relative to the opportunities they have.**

**More intriguing I think is that for the first time since the late 1990s there are no obviously cheap or expensive sectors or markets around the world.**

**In the late 1990s there was a huge valuation gap between dotcom stocks and old economy companies. A few years later there was a huge gap between developed and emerging markets. Just two years ago the FTSE100 index was back at the level it first reached in 1995. All of these valuation anomalies have disappeared. Some individual stocks are highly and lowly valued but not many. In the US we have a growth manager and a value manager so you would expect there to be no overlap in the stocks they own but now they both own companies like Hewlett Packard, IBM and Microsoft in technology as well as Carnival Cruises and Stanley Black and Decker.**

**The valuations, balance sheets and dividend growth prospects of many individual companies look more attractive now than they have for a decade or more. Our largest listed investment, Vodafone, is a case in point. It yields 5% compared with ten year gilts yielding 3.5% but I think global mobile telephony is a much more attractive investment proposition than lending to the UK government over the next ten years.**

**So despite all the big picture problems we think the opportunities to invest in individual companies are very attractive and the balance of risks and rewards weighted in our favour. Over the last five years making the right asset allocation decision has been crucial and individual stock selection has been less significant. Indeed stock selection had a negative impact on our overall results in 2010 itself. We are now putting more emphasis on stock selection in several different**

**ways. First and foremost by striving for outperformance of the local indices in each region. Secondly by letting the regional managers choose stocks from outside their region if they seem particularly attractive. And thirdly by looking at opportunities to invest in more specialist funds or portfolios where they would complement what we are doing already.**

**Foreign & Colonial is in a much stronger position than a year ago. We are on the cusp of private equity cash flows turning positive and income moving ahead again. We have advantages of scale, reach and experience which few can match. We are confident we will deliver on our objective of increasing your income and your capital.**