

Summertime blues - Looking back, looking forward

Investors will not look back fondly on the summer of 2011. Following on from the tragic events of the earthquake and tsunami in Japan, sentiment in global markets has been dominated by the European sovereign debt crisis and concerns over whether policymakers possess the will or the way to resolve the issue.

Today, the markets have responded positively to the series of measures announced overnight by European political leaders in an attempt to avoid the disintegration of the Eurozone. We will cover the likely implications of these measures over the next few days as the detail becomes clearer but, for now, the key points of the three-pronged plan are to:

- Agree a 50% write-down for bank holdings of Greek debt
- Recapitalise European banks to the tune of €106bn by June 2012
- Increase the size of the main Euro bailout fund, the European Financial Stability Facility (EFSF), from €440bn to €1tr

Based on the reaction of global equity markets seen so far today, this seems to have provided markets with evidence of the united political stewardship they have been looking for. As we have often stated in previous bulletins, a bailout package, whilst necessary, is not in itself sufficient to create the conditions for a stable Eurozone going forward. Without a move to create a closer fiscal union, any relief may prove to be short lived.

So it was interesting to note that in addition to the three main points, the announcement also confirmed that there will be tougher controls in future on the budgets of member countries, integration of taxation and a leadership structure for running the Eurozone. Whilst the agreement stopped short of full fiscal integration, the implication is plain – in order to survive, the Eurozone will need to more closely resemble a super-state with much closer financial ties for all member states.

In the meantime, investors are trying to make sense of the current mix of rising inflation, record low interest rates and volatile stock markets which, on the face of it, provide few clues for savers and investors. But the challenges remain the same – the long-term financial goals we set ourselves need to be met. Complacency or inaction will not enable our money to work harder. Are there opportunities presented by current investment markets? And if there are, how can investors exploit these?

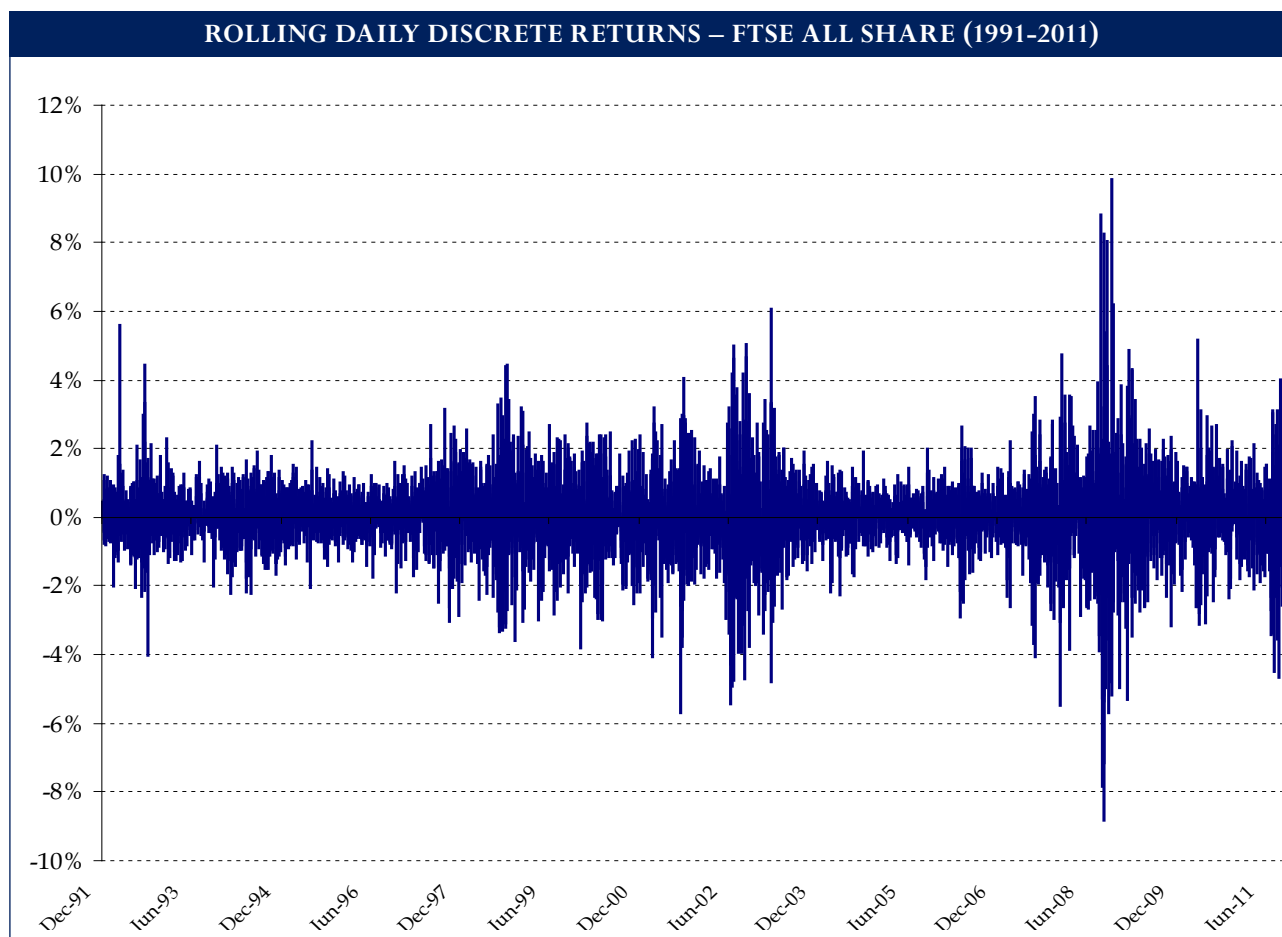
Market wobbles

Stock markets never go up (or down) in straight line and short-term volatility is an inherent feature of equity investing. But it is unsettling – meaning that the biggest danger for the long-term investor is to get shaken out of the markets by losing their nerve in times like this.

The full scale of stock market jitters over this summer’s Eurozone crisis can be seen in the chart below. Since mid-July, daily fluctuations of 2% or more in the FTSE 100 Index have been five times more frequent than usual. There have been twelve one-day falls of more than 2% which, more often than not, have been followed by a subsequent rise of equal magnitude. However, as always, it is the losses that grab the headlines.

Not since the immediate aftermath of the collapse of Lehman Brothers in September 2008 have we seen such large daily fluctuations. Experienced investors appreciate that losses are only real if they are crystallised and that, over time, markets reward patience and the ability to maintain the long-term view.

Short term volatility



Source: Financial Express Analytics. Data to 6 October 2011. Please be aware that past performance is not indicative of future performance.

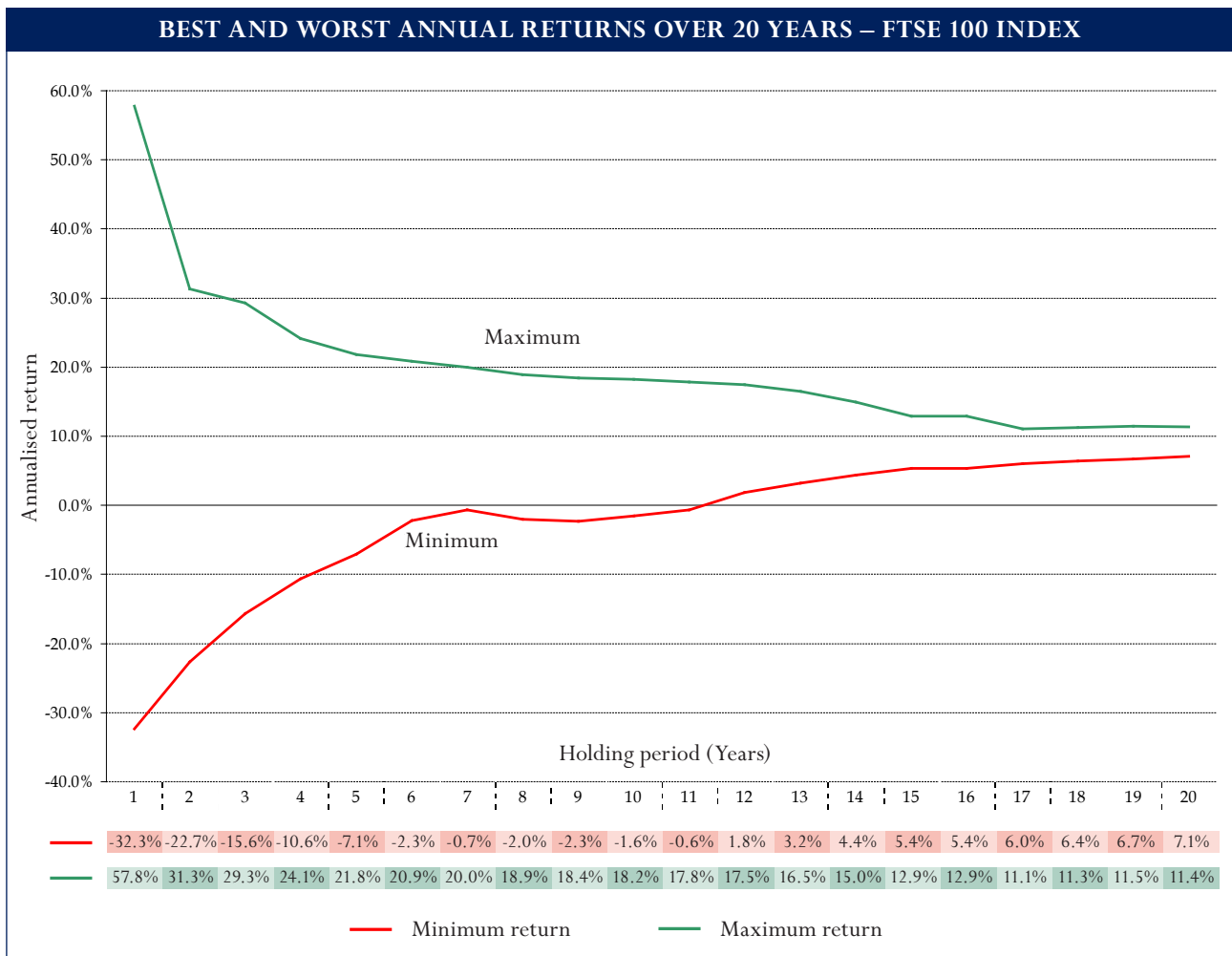
Keep your eyes on the horizon

In volatile times, it is tempting for potential investors to adopt a wait and see approach and remain on the sidelines, waiting for the reassurance of a sustained rise in prices to make them feel ‘confident’. Of course, to do so means missing out on those gains. It is one of the ironies of stock market investing – in what other market do consumers wait for the price to go up before they feel comfortable to buy?

Difficult though it sometimes feels, investors need to recognise that they will not begin to address their long-term objectives by taking a short-term view of their investments. No-one can successfully and repeatedly get market timing right. Knowing in advance when to buy into a market or to sell out of it, and to get this right consistently, is the investment equivalent of believing in alchemy.

It still holds true that it is time in, not timing that counts.

The chart below illustrates the point. Looking back over the last 20 years of the UK stock market, those who invested for just one year would have endured extremely volatile returns. The best one year period would have returned 52.3% but the worst would have seen a loss of 34.4%. However, over the longer term the returns are more consistent, smoothing out the short-term volatility. Short-term investing is a high reward/high risk strategy but increases the likelihood of losing significant amounts of your money and failing to meet your long-term goals.



Source: Financial Express Analytics. Data to 6 October 2011. Please be aware that past performance is not indicative of future performance.

Price is what you pay, value is what you get

In the midst of the current uncertainty, the sentiment driving markets can easily sway investors towards making the wrong short-term decision based on depressed share prices. But for every investor who sees lower share prices as a reason to sell, there is another who sees an opportunity. After all, whatever the asset class, the price you pay is a key determinant of future returns.

The skill of an investment manager is to identify and invest in quality companies able to deliver earnings growth over the medium to long term. What matters is the manager's ability to 'cut through the noise' of volatile markets and continue to focus on the fundamental qualities of the businesses in which they invest. The intrinsic value of a business doesn't move up and down day to day as the share price might suggest.

For many companies their fundamental qualities are not being reflected in current share prices, which are instead being largely dictated by the wider macroeconomic environment. And this isn't just true of a few individual companies. For example, European markets are currently trading on valuations which are some of the lowest for 40 years. For a potential investor or someone already invested, the decision is a simple one. Are such low valuations for quality companies a reason to sell, to hold or to buy?

The Price to Earnings (PE) ratio is one of the oldest and most frequently used metrics for valuing investments. Using the current PE ratio against the long-term average can give investors an idea of how 'cheap', markets are priced in relative terms.

The table below, demonstrates that on this measure alone, the UK, US and primary European market are trading at significant discounts to their 10 year average valuations. Furthermore, broader indices representing the emerging and developed economies are showing similar valuation levels. For many investors, this represents an interesting buying opportunity.

Price to earning ratio

REGION	INDEX	OCTOBER 2011	10 YEAR AVERAGE
US	S&P 500	13.3	17.7
UK	FTSE 100	10.6	27.0
Germany	DAX	10.6	21.3
Emerging markets	MSCI Emerging Markets	10.3	12.5
World	MSCI World	12.2	17.1

Source: Bloomberg. Data to 14 October 2011.

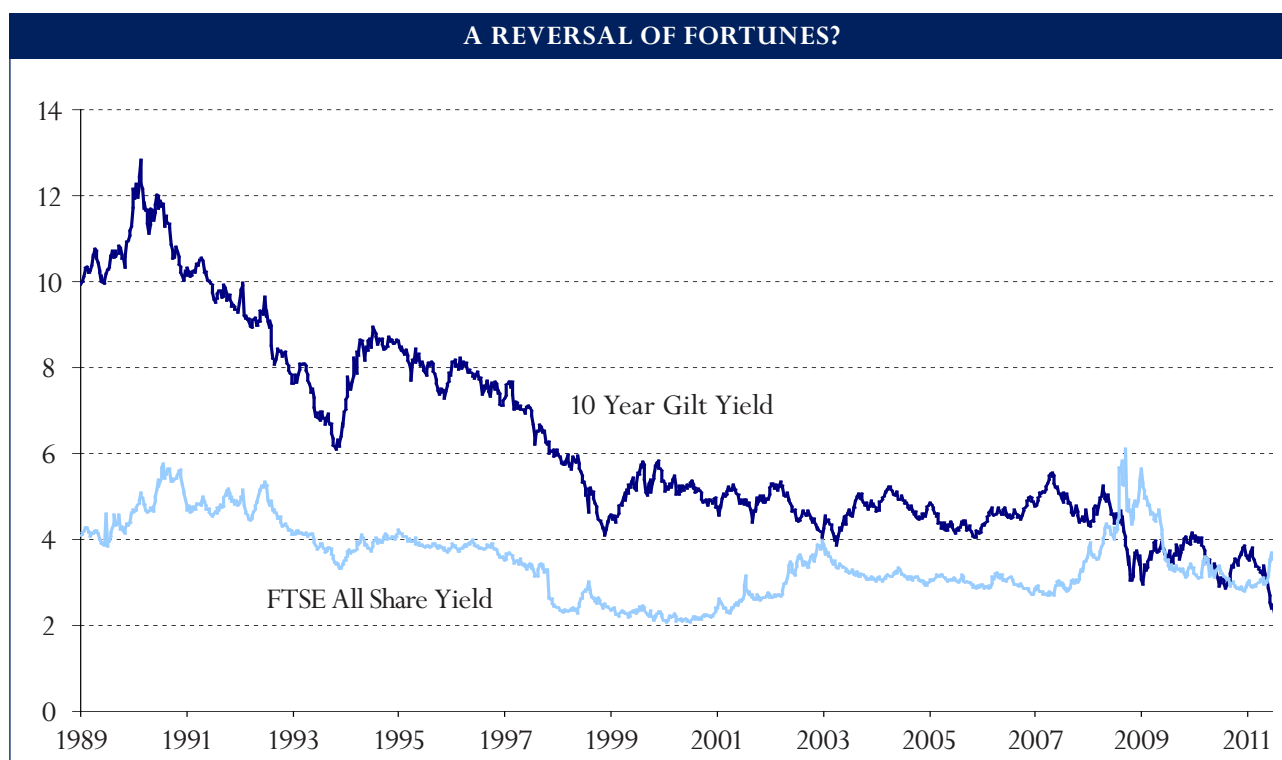
A lesson from the history books?

There are pointers from the past that provide further indications that current equity valuations might prove an attractive ‘entry point’ for long-term investors. As we’re constantly reminded, past performance is not a guide to future performance, but investment history can still teach us a thing or two. Whilst there is no crystal ball, investors need to decide whether the case for equities has changed for ever or whether the lessons of the past still hold true today.

It also needs to be remembered that equities are just part of the solution for investors and that, whilst stock markets have endured a difficult period, other asset classes have shown resilience – indeed good positive growth – demonstrating the continuing value of a diversified strategy. Gilts in particular have done well as equity markets have struggled.

To illustrate the relative returns of Gilts and Equities, compare and contrast the yield on a ten-year gilt, seen as the ‘risk-free return’ benchmark, to that from UK equities. In the last 50 years or so, investors have taken the view that a gilt should yield more than its higher-risk equity counterpart, to compensate for lower growth prospects and the damaging effects of inflation. However, on rare occasions (only four times in the last 50 years) equities have yielded more, a scenario that has coincided with a low point for equity valuations, to be followed by a rally in equity markets.

Today, the FTSE All-Share yields 3.35% (net of basic rate tax) compared to 2.67% (gross) from a ten-year gilt (source: Financial Times, 26 October 2011). Are we at a similar crossroads again now? It is ironic that at a time when governments face downgrades by rating agencies and calls to recapitalise banks (particularly in the Eurozone), Government Securities are close to yielding their lowest at almost any time in their history. Equities, by contrast, offer both a better prospect of capital gain and a higher current income yield, which surely warrants serious consideration from any long-term investor?



Source: Bloomberg. Data to 14 October 2011. Please be aware that past performance is not indicative of future performance.

The current volatility and uncertainty reinforces some key investment principles. There are no guarantees that come with investing in real assets and no single asset class is the panacea for all investors over all time periods. A well-diversified investment portfolio is likely to provide the best approach for achieving real returns over the longer term but within acceptable limits of volatility.

Difficult market conditions also highlight the importance of utilising the skills of the best investment managers. It is when markets are tough that the true ability of managers to generate returns is tested. Diversifying, by finding managers with different investment styles, also helps reduce risk – different styles will perform better in certain market conditions, meaning that a portfolio spread across a number of high-quality managers provides both diversification and the prospect of good returns. Investors should also look to diversify their portfolio by embracing different asset classes, such as Gilts, Property, Corporate Bonds and Alternatives.

In the short-term, markets may well remain volatile. For those uncertain about whether ‘now is the right time to invest’ and are therefore reluctant to commit large lump sums of capital to the markets, there are clear advantages in drip-feeding investment into the markets - either through phased investment or regular savings.

In that way, investors can overcome the worry about investing one day only to see the market fall the next and also benefit from the potential advantages of pound cost averaging. A well-diversified portfolio will also reduce the impact of short-term volatility.

In short, focusing on the longer term and building a balanced, diversified portfolio will help to achieve your investment goals. Despite the current volatility seen in the market, quality equity investments – which can be bought today at valuations significantly below their historical average levels – should be part of a well diversified portfolio.