Under the Carpet or the Great Escape

December 2010

Last week the Daily Telegraph, in its main headline, exhorted investors to take their money from the building society to put in shares. It is astonishing that this should be considered the main news item on any day. Have the lunatics have taken over the investment asylum!

In our experience, clients are becoming more, not less, cautious and it is important not to chase returns just because interest on building society deposits is so low.

We have been using our risk profiling tool for a few years and the predominant result is for clients to want the majority of their money invested in low and medium risk assets, typically 50% low, 40% medium and 10% high. The question is what constitutes low and medium risk.

The best way of differentiating is by looking at the volatility of funds / investment trusts. Volatility measures the degree by which an investment rises or falls in a given time. The volatility of cash should be extremely low at 1 or less, while the volatility on gilts is typically around 7. The volatility on the FTSE 100 share index is 17-20 with emerging markets equities 30+. (source ishares)

Risk	Volatility
Low	0 - 8
Medium	8 - 17
High	Over 17

Working on this basis an exchange traded fund tracking the FTSE 100 index is going to be higher risk.

I will return to this later.

In the past, it was typically thought that stock markets predicted the economic conditions 12 months ahead. If we look at this year's stock market performance (stock markets up 10% or so), then 2011 should be reasonably benign.

If this is the case and we have slow growth with no great panics along the way I will consider it to have been the Greatest Escape possible…….

The debt has transferred from the private sector (particularly banks) to governments. If it leads to limited economic impact on the vast majority of the population, through lower mortgage costs and diminishing private debt, it will be not much short of a miracle.

However, let's just consider some of the headwinds that the world faces as it enters 2011.

The eurozone ~ each month the politicians and bureaucrats carry out another Houdini act as they avoid another lurch into the abyss. This month it is Ireland and next year will it be Portugal or Spain or both.

I look at the simple reality: banks lent lots of money to investors in property and values are below the amount of the debt (especially in Ireland where property values have fallen by 40%). The banks have no incentive to foreclose because if they do they have to own up to the losses on their balance sheet.

Add to this the exposure of the main banks in Europe to the debt of Greece, Ireland and others and many observers worry about the solvency of not only the countries but also the banks who have lent the money.

It is interesting to note that when the crisis first broke in 2008, European politicians blamed the Anglo-Saxon economic model as flawed. Now, as the exposure of banks, particularly German and French, to dodgy debt has become known there is less posturing.

The stress tests, which gave all the European banks a clean bill of health in the summer failed to predict that just four months later the Irish banks were so indebted that they brought the country to its feet. What other problems might have been brushed under the carpet?

Will the euro survive? The answer to this primarily depends on Germany's appetite to continue to bail out the periphery countries. The probable alternative would be for them to leave the euro and restore the deutschmark, leading to a dramatic revaluation making their exports less competitive.

This would raise more questions than answers such as would France join them, would it be the end of the EU project, what would the political impact be from Brussels to Madrid?

Spain has to finance €300bn of debt in 2011 and it is already paying 2% more than Germany for 10 year debt. The impact of rescheduling or default by a European country is difficult to predict but is likely to be painful, and will have a knock on impact across the region.

But it's not just Europe where economies face headwinds, there is an even bigger question mark in the US. The continuation of the Bush tax cuts, and rejection of a bipartisan austerity programme will result in ever-increasing government debt. It can't go on for ever.

The US has the largest public sector debt in absolute terms in the world, but unlike the UK and Japan where government debt is financed primarily by residents, the US relies on foreign money to provide 50% of their debt.

The impact of the US being unable to finance itself hardly bears contemplating. While the debt can be financed in the short term by more quantitative easing the US would have to embark on a massive austerity programme which would undermine global trade and undermine the dollar further as a reserve currency.

This would generate a massive shock to markets. Few appreciate that the bond market (government and corporate debt) is far larger than stock markets and none comes anywhere as big as the US - a potential headwind!

As always there are the geopolitical risks associated with places as varied as Korea and Iran as well, but that's nothing new.

So, as I look back on 2010, a year when I was too cautious in my forecasts, I ask the question; should we join those who believe that we are going to effect the Great Escape and embrace more risk in portfolios?

It would be fantastic if the world (particularly the so called developed) could work through the debt mountains with slow but sustainable growth. However, the development of the crisis from being one of liquidity post Lehman, to one of the solvency of nations now means that there are still big risks out there.

In Martec we are evolving an investment strategy with the objective of capturing a reasonable part of any equity market upside but not being too exposed on the downside. Over a 2–3 year period if a portfolio can deliver 75% of the growth but limit losses to 25% of stock market falls, then we should feel satisfied.

Over recent months, we have analysed core multi asset funds to assess their chances of delivering this kind of performance and complement it with monthly purchases of higher risk, global dividend earning equities.

Over the next few months we will be reviewing client portfolios with a view to positioning them to try to achieve this.

Retirement Planning

As mentioned in our last newsletter the emergency budget outlined two key changes for those close to or taking their pensions.

Firstly there was the change in state and government related pensions to increase by CPI rather than RPI. The Retail Price Index has been around for 40+ years and has provided a measurement of a shopping basket of typical household costs including housing.

The Consumer Prices Index set out to provide consistency across Europe and is perceived as being more representative of costs. The argument is that most pensioners do not have significant housing costs and that expenditure is modified as prices go up. The ultimate effect is that pensions are likely to increase by ca 1% less pa at current estimates.

Also significant in the proposed Finance Act 2011 is the ability of pensioners, post 75 to continue to draw an income from their pension fund. If they have in excess of £20,000 pa secured pension, then the amount they can draw down from their fund, less income tax is significantly increased.

The tax charge on passing the pension fund to beneficiaries will be 55%, a significant improvement on the ca 82% which it was before. This opens up a lot of planning opportunities for those with pension funds in excess of £100,000 and provides a good incentive to build up your pension fund.

As this probably won't reach you until after Christmas, we would like to wish you a very prosperous 2011 from Juli and me.

Alistair [signature]

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