



2008 has gone but 2009 is upon us

All the fund managers' results are in for 2008. They make grim reading.

It is the time of year for reviewing what has gone before and planning for the future. As you know our general belief is that it is, at best, incredibly difficult and expensive to forecast market moves or to pick stocks. In fact trying to manage money by timing markets or picking stocks more often reduces then enhances returns over any meaningful time period. This means that we are not big fans of the crystal ball columns that have been filling the broadsheets for most of January.

Usually I might share what I have found humorous over the year in the hope that we might share a smile, but in the current climate that does not feel like the right thing to do. It has been a momentous year for world finances. Our children's children will learn about 2008 in their history and economics classes. I wonder how 2008 will look from the vantage point of 2018.

In any event, I would like to look back briefly at 2008 and to discuss, again briefly, some of the current hot topics in finance.

2008 was an amazing year, in the worst sense, for stockmarkets and it is this subject that is probably of most interest to you. But what really set stock markets skittering was property prices and credit markets. Mortgage lending in the UK has collapsed. Depending on which statistics I use, new mortgage lending has reduced by between 70% and 90%. (<http://www.bankofengland.co.uk/statistics/> has lots of relevant data).

Northern Rock, Lloyds TSB, RBS and HBOS are all effectively nationalised. It is a similar story in the USA though the numbers are bigger – Fannie Mae, Freddie Mac – both nationalised. Bear Stearns, Lehman Brothers, Goldman Sachs – all gone or unrecognizable. AIG effectively nationalised.

Any sooth sayer who predicted the above in January 2008 would have been laughed out of their office and out of their employment. The only crystal ball gazers that I am aware of that predicted much of this correctly are those who consistently forecast disaster every single year. They will have their 6 or 12 months of fame.

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I will not dwell on the details. Enough has already been written on this subject. Essentially credit started to get a little tight, the US property market started to see prices go down for the first time in most investors' memory, banks became very nervous about what they had on their balance sheets and what others had on their balance sheets. This meant that the banks very rationally stopped lending as much to customers and to each other. This caused a crisis in credit markets and a very serious loss in confidence in all sectors. Companies and individuals became concerned that they would be unable to borrow and/or unable to repay existing borrowings. And so it went on.

The net effect is that the FTSE 100 had its worst year on record – 31.3% down. 1974 was worse but the FTSE100 had not been invented then. Most major economies suffered severe losses. Japan and Hong Kong suffered even bigger losses (in local currency terms) than the UK. 23 countries suffered losses greater than 50% (in dollar terms). Globally October was the worst month by some distance. In America in October the Dow Jones Industrial Average moved by more than 5% six times. A daily change of 5% occurred only once in the 50s, once in the 60s and once in the 70s. However a one day movement of more than 5% happened 13 times in 1931, 37 times in 1932 and 20 times in 1933.

All sectors were effected – small, large, value, growth and UK and non UK markets. Small and value companies were hit particularly hard and suffered greater losses than the main market. This often happens when a market is in decline. As I have covered in previous notes, the small company effect and value effect are enduring and can be found globally. Over the long term we expect returns from small companies and value companies to be higher than main market returns.



Some commentators are arguing that because virtually all shares struggled and because property prices have also collapsed that asset allocation as envisaged in Modern Portfolio Theory does not really work. This is quite incorrect. Modern Portfolio Theory concludes that assets that have low correlation factors can be grouped together to produce pleasing medium and long term outcomes. Sometimes assets which are not generally closely correlated will behave in the same way. Also correlation coefficients can change. Asset classes that performed satisfactorily included both conventional and inflation linked government securities. Also the particular type of fixed interest security we recommend performed tolerably well, and spectacularly when compared with other more conventional fixed interest strategies.

So what does the future hold and how should we react?



We do not know what the future holds and deeply distrust those who tell us that they can foretell the future. We continue to have a deep faith in investment in property and equities. At its core this is really a deep faith in capitalism – in man's desire to build wealth.

However at times like this the pain of these investment beliefs is palpable. As there have been pages and pages written on what happened in 2008, so there are pages and pages written on risk. The fashion for many years has been

to make the words risk and volatility interchangeable. This is inaccurate and misleading. Volatility is but one aspect of risk. There are many other aspects within the context of wealth management but the single most important risk is that you, our clients, do not achieve your key goals.

Your key goals are disparate but almost universally you would like to be confident that your finances will deliver whatever they are required to deliver.

Typically there is a cashflow requirement and often a requirement for capital to be available at some point either for the next generation or for philanthropic purposes. There is also often a goal that is less easy to measure - to feel generally confident about finances. As long as there are sufficient cash resources and planning is kept up to date the very real pain of seeing values fall should not, at least in the short term, impact on cashflow payments. Unfortunately the falls we have all suffered are an integral part of the investment picture. If investing in a portfolio of stocks or properties was a sure bet then investors would reap the same long term rewards from these portfolios as they would from risk free assets. And we know that over long time periods that such a return has been very poor compared to the return on equities and property.

Nice words but what to do?

We have two major concerns for 2009:-

1. That investors will believe that 2008 was the end of the pain. As I write this we have been through about 10 weeks when major stockmarkets have gone neither up nor down. This can make us all feel that the worst is over. There is evidence that this assertion is true, but equally there is evidence that worse may be yet to come. We all like to see our beliefs validated and usually have an inbuilt bias towards hoping for and then believing in the more optimistic short term outcome. Unfortunately there are several examples of falls in stockmarkets being followed first by drifting values and then by a further drop.
2. Deflation. We are in a position where the markets best projections of inflation are that it will be a negative number in the UK and in other developed economies. If deflation takes hold there are many horrible social consequences but the investment consequence can be that virtually all assets decline in both nominal and real terms. During these times it is only conventional (non index linked) sovereign debt that is likely to show positive real returns. And some commentators are now questioning the security of sovereign debt in developed Western economies.

We recommend that nearly all clients hold fixed interest assets as well as property, equities and cash. Fixed interest assets such as corporate bonds and gilts generally offer very different returns from equities and help to dampen the stomach churning volatility of stock markets. With regular rebalancing profits can be captured. We have been long term fans of two particular types of fixed interest (or debt); these are short dated highly rated bonds and index linked gilts.



As mentioned above, the inflation outlook is clear but very unusual. We believe the best estimate of inflation is the market's estimate. It can often be wrong (for example look at the changes in these numbers in Spring and Summer of last year) but it is the best we have got. Lending money to the government over a similar time period should produce a similar return regardless of whether the debt is via a conventional gilt or an index linked gilt. (The return on the index linked gilt may be a little less to reflect the "insurance" against rampant inflation). The arithmetic demonstrates that for the very first time since index linked gilts were issued the market expects inflation to turn negative.

In these circumstances the yield on index linked gilts will fall and the ultimate repayment obligation will be reduced. At the time of writing (January 2009) this calculation implies negative inflation in 2010 and 2011 with inflation returning in 2012 and rising in 2013 to between 3% and 4%. The equivalent calculation in Japan and the US is more depressing where markets predict deflation (or nil inflation) for the next eight years or so. (The calculation in the US is more complicated since some of their equivalent securities have a return floor).

How does all this affect our investment advice?

We conclude that negative or nil price inflation in the UK for the next 10 years is rather more unlikely than likely. The UK and others have an inglorious tradition of printing money and deflating debt away. Many clients are concerned to maintain the real value of their capital. With many index linked gilts trading below par we will continue to recommend that clients hold and purchase these securities, though we will be concentrating on the medium dated index linkers. Any capital gain is also currently free of Capital Gains Tax.

Conversely we find it difficult to recommend conventional gilts. Prices have now increased substantially and yields on shorter dated gilts are sub 2% and in tax terms they offer an unrelievable capital loss. Since we still believe in holding some conventional debt securities and will not be recommending many gilts we will have a particular interest in corporate bonds and more particularly still UK corporate bonds which are at least producing attractive yields.

Other than these minor points our core investment advice will be to continue to invest scientifically. We are not stubbornly immovably wedded to our investment strategy and continue to access some of the world's leading academics in investment theory. We are however very wary of newly discovered panaceas, apparently respectable organisations will doubtless launch huge numbers of such products in 2009. Great buying opportunities are by definition only ever obvious many years after the event, and they are easy to miss.

Ben Sherwood
Principal

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References and data are available at

<http://www.bankofengland.co.uk/> accessed on various dates between 5 January and 31 January 2009

<http://www.dmo.gov.uk/> accessed 24 January 2009

<http://www.bbc.co.uk/> accessed 24 January 2009

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