



Update on recent events

Are you concerned about recent market volatility? Is it time to get out?

Many of our clients have portfolios invested across a wide range of assets including substantial exposure to the equity markets. Since Spring of this year most major markets have been volatile and are trading at lower levels than two months ago.

Why have markets deviated from their relentless upwards path?

It is most unusual for markets to rise as smoothly as they have since March 2003. Over the last 75 years the US and UK markets have grown at an average rate of between 10% and 12.5% depending on which set of data we use. However if one omits the best month each year these figures drop to between -3% and 1.5% per annum. We conclude that the growth that equity markets deliver arrives in spurts.

Clients that receive quarterly valuations should be surprised not if their portfolio performs poorly for two quarters, but if their portfolio performs really well for two consecutive quarters. This is not an easy nettle to grasp – we hardly expect clients to celebrate a flat or negative quarter. It is important however to understand that *on average* at least two flat or negative quarters per 12 month period are to be expected. Counter-intuitive isn't it? But so much about investment is counter intuitive.

In fact since March 2003 we have enjoyed 7 or 8 significantly rising quarters out of 13. Our advice to clients who have been invested for over 12 or 18 months has been to **sell** equities to get the portfolio back to the agreed long term asset allocation. This means that clients have not enjoyed the full benefits of rising equity markets over the last three years. It also means they have not suffered the full pain of falling equity markets over the last 3 months.

I covered market timing in a recent article* so will not revisit that here. Volatility is a necessary part of the equity return recipe – without the volatility there could not be the returns. Historically volatility has caused long term equity investors much less pain than short term investors. Over the period 1956 – 2004 the best annual return was 151.4% and the worst was -51.6%. However the worst ten year outcome was 0.8% per annum and the worst twenty year outcome was 8.9% per annum. (The best over the same periods were 31.6% per annum and 22.9% per annum)

Perhaps that's too many figures and perhaps looking at past performance really is steering a boat with the light on the stern. My key point is that our clients invest for the long term and will receive the long term return available on equity investment on the equity portion of their portfolio. If your investments have lost value recently do not sell them, in fact consider buying more. Expect more losing and mundane quarters than fabulous ones.

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So why has it happened?

One key factor – interest rates.

Major markets are nervous about inflation. In fact major markets are nervous about central banks reaction to inflation. In the US core inflation rose last month and in the UK graphs can be drawn to demonstrate that both major inflation measures are creeping upwards. Inflation numbers are regularly criticized for being inaccurate or irrelevant. But all other things remaining equal we could expect central banks to raise interest rates to contain inflation (though this is less likely in the UK). The markets are concerned that briskly rising interest rates will hit economic growth.

If borrowing becomes more expensive, the argument goes, then firms will be discouraged from expanding and we will enter a period of decline in economic growth or even, that lovely expression, negative growth. Unexpected inflation is also bad for economic growth so if the interest rates don't get us then inflation will.

The arguments summarized incredibly briefly above are cogent but what should you do right now? What are the potential worst and best cases?

As you know we oppose conventional views regarding market timing and stock selection. It is not in our view possible to make decisions about markets and stocks that add materially to portfolio returns, it is however very easy to get these decisions wrong. Further the point is that through making the decisions you are adding to your costs which is yet another drain on your total returns. So our advice is to stay invested and talk to us.

Worst case – interest rate rises cause further falls in worldwide markets but also mean that the fixed interest rate portion of your portfolio will drop in value. Corporate bonds and conventional gilts will drop in value – this is an unpleasant combination. Conventional gilts are generally poorly correlated with UK equities but not always. In 1994 for instance the FTSE All Share fell 5.9% (total return) and long term gilts fell by 6.9%. In the same year cash returned 5.2% and inflation was 2.9%. The one saving grace for many of our portfolios here could be index linked gilts. These are a government guaranteed inflation hedge – if inflation takes off then the yield, and eventually the capital value, of these index linked securities will rise. The data on index linked securities does not go back as far as all the other databases but index linkers are generally more closely correlated with stock markets than conventional gilts, but, again, not always. So in the worst case stocks will drop, fixed interest assets will drop, the economy will suffer, property prices and yields will suffer and the only positive real return is likely to be from cash. And then cash will only be a good place to be if inflation does not take off again.

Our advice – stay invested. Do not try and beat the market – just collect the returns that it offers. In the long term (ten years) you are likely to get the best results from a balanced portfolio with exposure to stocks and property; in the short term we must all fight the natural intuition to sell in a falling market.

If you would like a fresh perspective on your financial position from genuinely independent professionals please contact Ben Sherwood on 01442 220713 or email ben.sherwood@hllp.co.uk

PS – No I haven't forgotten about falling commodity prices assisting in the market downturn but struggle to see this as the key factor in the current uncertainty.

*Included in previous quarterly bulletin – please contact us for a copy

For more information on any of the issues raised your current Hillier Hopkins contact will be happy to assist you. Alternatively, please call us on 01442 220788 to speak to one of our advisers. Hillier Hopkins LLP are registered to carry on audit work by the Institute of Chartered Accountants in England & Wales and authorised and regulated by the Financial Services Authority.

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