



## Markets, banks and great investments

At the time of writing, equity markets have lost money over 1, 3 and 12 months. The credit crunch is still with us and Northern Rock has been nationalised. Many investors are asking, "When will we have reached the bottom of the market?"

Broadsheets are discussing various strategies to deal with the poor returns generated by conventional strategies – in the last two days I have received details on all manner of technically complex vehicles including guaranteed investments involving the prospective client in 99% gearing, "130/30 strategies" which give investors 100% equity exposure but allow managers to "short" some stocks to increase returns and an "absolute alpha" fund that can "lock in profit whatever the market". Each one of these concepts is being promoted by highly respected well established firms.

Yet we still continue with our basic strategies – agree client goals, design a thoroughly diversified portfolio with underlying exposure to over 1,000 stocks using asset allocation, deliver that asset allocation via pure asset class funds, control costs, control tax, rebalance regularly to take profits and review.

This is not another article on why market timing is a high risk strategy unsuitable for our clients. When markets produce poor returns, as they are currently, it is very difficult not to be seduced by persuasive literature regarding "super investments". One of our core beliefs is that investors do eventually receive a premium above the risk free rate if they provide capital to businesses. The premium may take time to be delivered and by definition is not guaranteed. But it will be delivered. Here are some statistics that I found about another investment that looks phenomenally beguiling:-

- Fully listed since 1985
- From January 1986 to December 1999 produced returns of 24.08% per annum, comfortably beating the main market index
- During the three year bear market of 2000 – 2002 the share price rose by 44.18%
- In 2003, 2004, 2005 and 2006 the shares beat the main market index
- Over the 20 year period to December 2006 the share price outperformed Berkshire Hathaway (the Warren Buffet vehicle) by 4.50% per annum
- The company acquired a reputation for making profits in good and bad markets. It made few expensive acquisitions and concentrated on what it did best. The company was 85 years old last year.

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This looks like a very attractive investment, and certainly more resilient than a boring diversified portfolio of funds.

The firm was approximately one third owned by its employees and was Bear Stearns. One year ago Bear Stearns was trading at \$150 + per share, it now stands at between \$10 and \$11 pending a takeover deal with J P Morgan.

Here is a slide from a presentation made by their Chief Operating Officer in February 2008:

### **Prudent Balance Sheet Management**

Balance sheet reduced to \$395 billion at 4Q07 from \$423 billion at 2Q07

Capital position is strong

Balance sheet liquidity substantially improved

Reduction in higher risk asset categories such as leveraged finance and subprime / CDOs

Here's a comment from a magazine article in 2004

*"with the company's low risk profile and strong controls, investors in Bear Stearns can sleep well, knowing that even a full-blown financial crisis is unlikely to cripple the firm"*

I have absolutely no interest in gloating over the sad departure of Bear Stearns. Their firesale to J P Morgan was a sad day for all, notably for the employee stock holders.

The points I hope to illustrate are

1. Respectable sensible analysis can be very misleading. For our target clients it is always wrong to place a lot of money into one equity, even if it appears to be an absolutely sure thing, even if it is incredibly tax efficient to do so because of employment status.
2. Diversification reduces stock specific risk. But it does not remove market risk.
3. Nearly all commentators such as MDs, FDs and analysts have a vested interest in seeing the stock they are involved in rising in value. Genuinely independent advice is essential.
4. Markets are unpredictable – this is the price of superior returns. Prices fall in the short term because individuals expect prices to fall. This will change at some point and investors that are still invested will profit.

If you would like to discuss this or any other matter do not hesitate to contact me.

**Ben Sherwood**

**Principal**

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Acknowledgements to DFA for their assistance, [www.bearstearns.com](http://www.bearstearns.com) for further detail, and [finance.yahoo.com](http://finance.yahoo.com) for data.

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