hillierhopkins LLP

Stockmarket Bulletin

The recent stockmarket falls are concerning for all investors. I thought you might like to know our views and reactions to these falls.

The falls in worldwide stockmarkets are being widely credited to investors' lack of confidence in debt markets, particularly the US mortgage market. There are also concerns about the collateralised debt obligations (CDOs) in the States. A hedge fund sponsored by the huge and respected Bear Stearns almost collapsed a few weeks ago due to the market re-pricing some of these securities. I will write a separate article on this shortly.

Fundamentally the cause of a stockmarket drop is that the price at which a share owner is willing to sell and a share buyer is willing to buy has dropped for many shares. A stockmarket drop does not mean everyone is selling - there are huge numbers of buyers as well as sellers. So are Hillier Hopkins buyers or sellers? We are neither. Each client's portfolio is bespoke but built using one of our model portfolios as a foundation. If it is right, in the long term, for a client to be for example 60% exposed to equities, then short and medium term volatility does not alter this position. The buyers and sellers are the speculators; our clients are investors. Relative to the market these speculators generally lose. Even if they are very clever their transactional costs are a huge drag on performance. Incidentally, several papers show that retail speculators (this includes market timers) are monumental losers compared to both the market and even deposit rates. The sub market returns of the speculator are, to a large extent the market plus returns of the investor - in any event most UK investors fail to even get close to market returns.

The volatility we are experiencing is the price of equity (and property) returns. If there were no volatility and no risk, the market would deliver a risk free rate of return. In fact there is risk and investors (not speculators) are rewarded for accepting this risk with a premium over and above the risk free rate. The premium is not delivered in a predictable manner - it cannot be by definition. Sometimes it can take years to appear. But, historically at least, it has appeared eventually. One of the keys (with property too) is never to be a forced seller. Hold on for the ride - it will be rough, unpleasant and downright painful sometimes; but the long term investor will be rewarded.

When increased returns arrive, they tend to arrive in sharp violent bursts. Trying to predict these is a mug's game. Think back to the two worst recent investment periods - the early years of this century and the early 70s. Calling the bottom of the market is an extremely high risk activity. Trying to catch a falling knife is one of the journalists' favourite analogies. We do not know when the next upswing will come and nor does anyone else. Stay invested - that way you will definitely catch the upside.

Two possible retorts to this argument are "Japan" and the fantastic John Maynard Keynes quote "in the long run we are all dead". What are we doing to reduce the pain? Every client holds a diversified portfolio both by market and by asset class. Diversified portfolios are the only investment "free lunch". The addition of diverse portfolio elements can decrease volatility and enhance returns. At the moment most equity markets seem to be suffering in some way. Your diversified portfolio contains an exposure to fixed interest. This boring bit of the portfolio is doing exactly what it is meant to. It provides a return poorly correlated to equities and reduced volatility. The particular fixed interest (or debt) securities you hold are exclusively short term high quality debt and directly held gilts. It seems likely that riskier corporate debt is being repriced - this means investors want a bigger return for lending to riskier entities than they have in the past - this means that the capital price of these securities is falling. We have argued for years that the increased risk associated with poorer quality debt are not well rewarded by the market. You therefore have no or virtually no direct exposure to these securities. So your high quality fixed interest securities will perform as they should do and will help to dampen stock volatility.

Summary

Stockmarket volatility is a necessary price of superior equity returns. Stay invested. If you are approaching your next major review we will encourage you to rebalance your portfolio to the agreed long term model.

Your money is invested in a diverse portfolio. The non equity components will perform differently from the stockmarket component.

Do not be sucked in to becoming a speculator - investors reap the lion's share of the rewards and have the best chance of achieving their goals.

If you have any queries at all, contact either myself or your usual Hillier Hopkins contact.

Ben Sherwood
Partner

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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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