



Quarterly Commentary

It has been another quarter in which there has been great volatility. Taking the quarter as a whole, the UK market is down approximately 7%, other international indices are showing even larger falls.

Bank base rates were also cut twice in the quarter ending at 1.0%. This provides a one off gain for gilts but means the net of tax rate on most savings accounts is now absolutely dismal when compared with price inflation.

Sterling also fell again over the period. This flatters the performance of non UK markets when reported in sterling terms.

These pretty wild fluctuations are disconcerting. The prospect of deflation is frightening. At times like these many speculators will be selling for a variety of reasons. These will include:

1. I bought at the wrong time and must cut my losses – this bear market has further to run.
2. I need to react to the new investment paradigm and rearrange my portfolio.
3. An old chum in the lounge bar has told me about the next big thing and how to get a slice of the action.

Academic investors will not, however, as a rule be selling. In general they will have been buying through the last quarter. For those that have a long term faith in capitalism and its ability to create wealth, investment continues during this unpredicted and unpredictable turmoil.



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In the long term markets are very likely to recover. Trying to guess when that will be is the high risk strategy – markets move in fits and starts – trying to get out before drops and in before rises makes it easy to miss the rises. Missing just a couple of the sharp upward spikes has historically had a devastating effect on total return.

The other main recent financial stories were the amazing tales of Bernard Madoff and Sir Allen Stanford.

It seems that Mr Madoff managed to fool many investors. The investors who were caught included intelligent, wealthy and articulate individuals. Newspapers report that many major banks were also “investors” in the Madoff structures.

At the time of writing the American regulator the Securities and Exchange Commission (SEC) has explained that their allegations regarding Sir Allen Stanford’s businesses are based on the sale of certificates of deposit promising “improbable and unsubstantiated high interest rates”.

How is it that bright experienced individuals were apparently caught out, or more accurately, sucked in to these arrangements? The press coverage that gives us all the priceless luxury of hindsight makes it seem remarkable that anyone invested. The relevant Madoff firm was audited by an unknown three man firm of accountants. Stanford’s accounts concerning a £50 billion empire were signed off by a firm of accountants operating from one room in North London.



The Madoff case shows how incredibly beguiling and attractive an investment can be that offers good returns whether markets are falling or rising. It is the panacea for all investment related woes. How wonderful to have an investment that can ride out all market conditions and deliver non stop positive returns after tax and after inflation. This is the proposition of many (and not all) hedge funds and absolute return funds.



We will always struggle to believe that such an investment exists. In order for long term investors to be paid a rate of return that is superior to the risk free rate (the risk free rate is usually held to be a treasury bill or gilt) there must be an attendant risk for which the investor is being paid. If that risk is an illusion then the market will quickly realise this and the price of the investment will rise and the return will then decline.

The horrible losses we have all suffered recently demonstrate that there is real risk in investing in equities. In the last quarter (in fact most of 2008) it has not mattered too much whether one has invested in large or small stocks, growth or value stocks, UK or non UK stocks. They have all fallen dramatically. This perversely reinforces the concept that investors will demand a high return for such risky investments. History suggests strongly that this is the case.

Madoff type investments appear silly in retrospect. At the time of the presentation however they are incredibly emotionally attractive. My advice is to be cold. Ask for the supporting literature. Ask the difficult questions. Investments that sound too good to be true are exactly that.

If you have any questions for me or my colleagues, including difficult questions, please contact me.

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