Newsletter

June 2008

Is it different this time? 'It' being the economic slowdown, the last of which was 2001-2.

I'm afraid it is. I looked at the newsletter I did this time last year (copy on our website at www.martec.org). At that time, I was confused why the oil price rise hadn't impacted more on the wider economy: I suspected it would. It has now!

However, I can't claim to have foreseen how serious the situation was going to become. We have to look back to the 1970s for a comparative oil and recessionary impact coupled with a secondary banking crisis and global inflation. Sounds familiar? The oil price rise has been dramatic as the following chart shows:

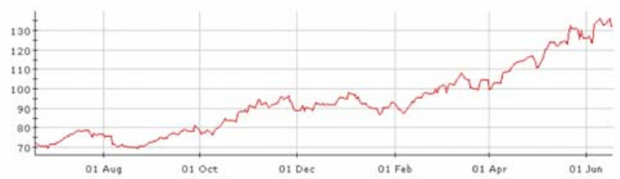

Figure 1 – Oil Prices. Source www.bbc.co.uk

Just to add to the gloom the International Monetary Fund (IMF) considers these economic conditions have not been experienced since 1929 – 32, and a reason for that is that asset prices (particularly houses) have become too high and are falling whereas in the 1970s they were rising.

So how bad is it going to get and what action should investors be taking?

The chances are that the economic and therefore investment environment is going to be difficult for the simple reason that it's going to take years to unravel the government, corporate and personal debt which has been built up.

We are probably in for 2-3 years of difficult conditions as governments, companies (especially banks) and individuals repair their own balance sheets.

A balance sheet shows the net worth of a business (its assets minus liabilities) and that's exactly the same for individuals.

There are three ways that companies or people recover their balance sheets, raise more equity capital, sell assets or earn more to reduce liabilities.

In reality, the third is the most feasible for individuals, the second possible where investors have gone into buy-to-let, but the first is unlikely unless an inheritance comes along.

A further problem is what decisions governments are going to make: they should reign back on expenditure and reduce deficits but the danger is that they will continue spending as if nothing is happening and that will undermine the whole recovery process.

A recession is inevitable in the US and UK and with the eurozone keeping interest rates at a high level, Europe won't be far behind. The government deficit in Spain, Portugal and Greece is three times the accepted eurozone level and worrying imbalances are going to have to be resolved which will put a lot of strain on the euro.

But consider this: it is possible the world's banks (mainly in the west) will end up writing off around $1,500bn, a figure that seems awesome until you consider that the planned spend on infrastructure, mainly in the east, will amount to ca $22,000bn over the next ten years (source Morgan Stanley).

There is a shift in economic power from the US and Europe including the UK, to China, Russia India Korea etc and this should be reflected in investment strategies.

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The key to investment decisions in this environment is to understand a few principles, some old some new:

- Stock markets may fall, but it takes a genius or a lucky person to pick the bottom of the market.
- Stock markets will reach their low before the economy turns.
- The long term future for successful investment will have much greater weightings in overseas equities – emerging economies, which are inherently more volatile
- This needs to be balanced by a larger percentage of investment portfolios in lower volatility funds / assets.

I therefore believe that the future construction of a balanced portfolio will be very different from the 1990s when it was typically 50-60% UK, 15-25% overseas equities and the balance in lower volatility assets.

In the last 10 years, there's been a dramatic development in alternative asset classes, and you can now gain exposure to virtually any asset you desire from timber through? Vietnam to soya. Property has grown and subsequently fallen but the most significant development has been the use of exchange traded funds (ETFs).

From early index tracking funds in the 1990s, there are now 330 plus ETFs traded on the London Stock Exchange trading everything from the FTSE100 index (4 ETFs) to the price of oil. You can also invest in short ETFs (Ie you gain when the price falls)

I am convinced that the growth of ETFs in commodities such as oil and agriculture (corn wheat soya) has had an effect of the increases in the underlying price.

A leading ETF provider ETF Securities has seen the asset value of its oil ETF grow by 2.3 times since the beginning of 2008. Their agriculture ETF has grown 3 times.

Since investors in ETFs are not going to take delivery of the oil they've bought, there comes a time when the market will turn and I do expect oil and food commodities to fall by the end of the year.

However ETFs also enable us to invest in a Global Water ETF of the world's leading companies in the water sector.

The key to building your portfolio is to combine lower volatility assets with core UK equities and exposure to higher risk assets such as ETFs built up over time. We are favouring amongst others the following asset classes:

- Money market funds: banks and building societies are not quite as secure as before, so it makes sense to spread your risk. We have been using a diversified cash fund for just under a year which has delivered excellent returns equivalent to 6.2% gross (source Transact client account Jun 08).
- Government Index linked bonds issued by UK and US, together with some exposure to global bonds based on my belief that current interest rate rise expectations will not go through.
- Long established investment trusts covering both UK and overseas equities.
- Asia and Eastern European funds built up through monthly purchases so as to average cost.
- Exchange traded funds (ETFs) investing in water, utilities and infrastructure which can provide a steady income stream.

Careful portfolio construction is vital in the current climate and if you would like more details of the way by which we can help you build a resilient long term strategy, please contact us.

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