Balancing the Books?

June 2010

Inflation or deflation, continued stimulus or spending cuts? Politicians and economists debate which it should be. This makes the decision for investors all the more difficult: should they persevere with the historic model of a diversified equity and bond portfolio.

In my experience, five years ago most investors would have described themselves as balanced, but relatively few appreciated that the typical balanced fund had 80% in equities and 20% in bonds etc.

Table A looks at the performance statistics of balanced funds.

Balanced Managed	YTD	1 yr	3yrs	5yrs
Average	2.1%	21.4%	-5.6%	26.2%
Best	7.8%	33.2%	48.6%	75.9%
Worst	-13.3%	0	-25.2%	1.9%
Martec Preferred 1	6.3%	11.5%	24.5%	67.2%

This highlights the impact of the fall at the time of the Autumn 2008 crash and shows that market timing is clearly as important if not more so than time in the market.

The fund which we have preferred as a multi asset core fund for both balanced and cautious investors has performed less well in the strong recovery of the last 12 months but has been outstanding when market conditions were dreadful.

In the aftermath of the crisis of 2008, people increasingly believed in a cautious managed approach yet their returns were very similar to the balanced approach as indicated in Table B below.

Cautious Managed	YTD	1 yr	3yrs	5yrs
Average	1.8%	16.6%	-2.6%	16.7%
Best	9.6%	31.5%	49.8%	70.5%
Worst	-22.6%	-34.2%	-24.1%	-5.8%
Martec Preferred 2	6.5%	18.7%	48.8%	67.6%

Source Trustnet

The second Martec fund, which we have been using for the last 2+ years, has a different investment philosophy to the first but has delivered similarly excellent results. Of course, remember that this isn't a guarantee of the future.

Both these funds are characterised by much lower volatility than the average and the avoidance (so far) of dramatic falls in value. It is a mathematical fact that if the value of an investment falls by 33%, it then has to increase by 50% to retain its original value.

Into this investment scenario we have to overlay the global economic situation and we are now moving into phase 2 of the 21st century financial crisis.

Phase 1 was categorised by the unwinding of the massive securitisation bubble after Lehman. Securitisation is the packaging of debts which are then sold to other investors and fuels mortgage debt, credit card loans, car loans etc. This has fallen by 90%+ since 2007 and has been replaced by an unprecedented transfer of private debt to government debt.

As a result, we are now seeing austerity packages from Greece to Germany, Britain to Beijing. The only major countries which are not (yet) participating are the US and France. The US can only delay austerity because the dollar is still seen as the ultimate reserve currency and France is, well France!

The following table shows the total government debt of leading countries, the % of their GDP and the average maturity of the debt.

Country	Total Debt $US Bn	Debt as % Of GDP	Average Maturity Years
US	12,311	86	4.4
Japan	9,325	184	6.3
Germany	1,469	44	6.4
France	1,656	62	6.7
UK	1,472	67	13.5
Italy	2,254	116	7.1
Spain	780	53	+
Greece	416	126	+
Canada	427	32	6.1

\+ No information available Source Financial Times / OECD

The fact that all the key countries have rapidly increasing debt reflects the need to find ever more investors prepared to lend governments money. How long will they do so?

One very positive statistic from the above table shows that the average maturity of debt in the UK is double all the others, which is a key reason we have retained our AAA credit status to date. The emergency Budget is likely to have confirmed our credit status but at what cost?

I can see no reason how, with all the austerity packages going on around the world, a double dip recession can be avoided.

If a government controls 50% of an economy and their expenditure is being slashed surely total GDP must fall. Yet stock markets around the world have not factored in a double dip. It is almost as if it has become the elephant in the room which no one is allowed to acknowledge.

Until we see countries or institutions rescheduling their debt as Argentina had to do in 2002, I don't believe we will have seen the bottom of the economic cycle and the conditions will be in place for a sustained rise in equity markets. Until then, there is just too much risk.

This brings me back to the decisions that investors should be making. If I am right about the double dip, and I would love to be wrong, equity prices are going to fall back from where they are and even dividends could come under threat.

The two funds I referred to previously have shown that they have the pedigree and appear positioned for stormier waters and therefore should provide a core part of your portfolio.

I still believe the inflation threat is real, even if it is preceded by a period of deflation, but ultimately governments will print money to help both finance and inflate the debt. Within our portfolios, it is relatively easy to get exposure to both sterling and dollar inflation linked bonds.

I continue to favour gold because it is the ultimate inflation / disaster hedge, and the emerging economies, including China and India are starting to build their own gold reserves. Anywhere between 5 and 10% of portfolios could be in gold and gold mining shares providing you appreciate it could fall in value by 25% in a short time.

Corporate bonds will be vulnerable to the impact of the double dip and also competition from governments as they issue new debt, but investment grade bonds should provide a higher yield coupled with lower volatility than equities.

There is always a case for an element of equities within the portfolio, but I believe these should centre around quality companies paying sound dividends – not just in the UK but especially Asia as well as a good global stock picking fund.

The UK equity market is too dependent on a few companies (such as BP, which shows the risks associated with individual shares), banking and mining shares, so it doesn't adequately reflect the global economy. Technology and global infrastructure engineering companies are not represented in the UK stock market.

Emergency Budget

Here is a snapshot of some of the key changes for investors:

- CGT for higher rate tax payers to 28%, with no indexation.
- Personal Allowance to £7,475 from April 6th 2011.
- Threshold for moving into higher rate tax will be reduced to offset this.
- VAT rises to 20% from January 4th 2011
- Pensions – annuitisation post 75 to be scrapped interim rules extend age to 77.
- Pensions tax relief for higher earners introduced by Labour to be modified
- State pension to be increased by greater of retail prices index and 2.5% pa

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