Newsletter

October 2008

When you're in the eye of a storm it is difficult to know what the world will look like once the gales subside and it's possible to venture out. I feel slightly like that now after the hurricane of week beginning 15th September. Although events are changing rapidly, there are a few deductions we can make.

It is highly unlikely that the UK government, or any other government, will allow a retail bank to go bust. This is highly important because the nightmare scenario is a retail bank going bust with a lot of companies' working cash which would start a domino effect of bankruptcies.

There is a strong feeling amongst the public on both sides of the Atlantic that they should not suffer, and have their houses repossessed, if banks are going to escape the consequences of their folly. The principle of 'moral hazard' means that people should accept the consequences of their actions. However, banks are the heart which pumps blood (cash) around the financial system and for that reason I reluctantly support the US bail-out plan.

The structure of banking is that for every £5 of shareholder capital it will have £95 of liabilities, almost entirely made up of the bank's depositors. However it increases its size by lending money to other borrowers, obtaining funds in the wholesale market, and crucially trading in a variety of structured products. This is where the problem has arisen: the value of these traded investments is significantly less than they were and in order to return to a capital / assets ratio of 5%, banks need to increase their capital, or reduce the amount of money they lend: in other words restricting the blood supply of the global economy.

This is why governments are looking at ways to keep the blood pumping. The US is seeking to take on $700bn of these so called 'toxic' assets so that banks don't stop the lending process. The Irish Government has taken a different approach: by guaranteeing individual and wholesale deposits in 6 Irish financial institutions they are underpinning the 5% capital adequacy.

So far the UK government solution has been to take over the assets / liabilities of Northern Rock and Bradford and Bingley and the taxpayer will have to meet any losses as a result. It's a slightly better asset-backed version of the US bail out.

When a bank only needs 5% capital ratio, the system is built on confidence and this is part of the reason why it brokered the Lloyds / HBOS takeover: the combined bank should be able to maintain a viable capital position, which HBOS wasn't able to do on its own, and therefore restore confidence for HBOS customers.

Whatever happens there will be a sustained period where borrowing is going to be difficult and a long and protracted recession as banks and individuals rebuild their balance sheets (see my newsletter June 2008 on our website at http://www.martec.org/archive.htm).

In these circumstances it is imperative that investors look to the long term and do not panic. While everything might look disastrous now, the reality is that large stock market falls are smoothed out the longer time passes. One has only to look at the 1974-5 and 1987 crashes to confirm this.

I have preached the mantra of diversification with a cautious core of investments and it makes sense to review your total portfolio, its risk profile and how that fits in with your overall appetite for accepting loss. We prepared a paper on portfolio construction in June and if you would be interested in a copy, please let us know.

It's not the end of capitalism, just banking as we know it, and that isn't necessarily a bad thing. I hope they will be more strictly regulated in future and concentrate on serving their customers and not their executive's pay.

However let's take a look at what might unfold over the next couple of years and what investors should be doing to manage their risk. You should be aware that these are my personal views and don't constitute financial advice; we will be happy to discuss your situation in person.

The recession is going to be as severe as it was in the 1970s if not worse. However it should be remembered that UK stock markets peaked in September 2000 at around 6900 and have never regained that level: they've fallen by 22% in the last year alone, so a large part of today's problems have already been discounted in UK equity prices.

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I believe it is unlikely that the FTSE will fall below 4000 so there may be another 20% downside from here, but I'm not expecting more. The key to underpinning the FTSE is dividends: we can expect earnings downgrades and dividend cuts (especially from banks) but how drastic will they be?

If the recession lasts two years, and it would be very severe if it did, the stock market will start to recover in the next 12 months. The time when it does will be when dividends stabilise and the yield on the FTSE All-share is better than cash and gilt yields. I am looking for this to happen in summer 2009: remember when stock markets start to recover they may move rapidly.

Property funds and Real Estate Investment Trusts (REITs) have been very seriously affected with falls in brick and mortar funds of 25-30% and REITs anything up to 60% in share price. I would avoid any that are heavily exposed to City of London offices but otherwise they can provide some useful income prospects.

Europe will face its biggest challenge since the advent of the euro: you only have to see that it's possible to get nearly 1% more interest on Italian compared with German 10 year bonds to know that there are serious tensions beneath the surface: watch this space!

Right now, I favour cash for obvious reasons but with two provisos: firstly you can spread your risk by investing in a money market fund targeting LIBOR (London InterBank Offer Rate) which offers higher returns than the building society: we have been using a fund which has provided 5.8% net of basic tax over the last year (Source Transact client account September 08).

The second proviso is that if we are headed for a lengthy depression / recession, interest rates will fall significantly and with fewer banks on the high street rates may be less competitive. All of which favour gilts.

Government Treasury Bonds, or Gilts as they are known, are issued by the UK government (you can also buy government gilts from other countries) and have a predetermined maturity date. There are 24 different gilts in issue and let me look at an example:

Treasury 5.25% 2012: this means that £100 stock will be repaid by the government on 7th June 2012 and an investor will receive £5.25 for every £100 of stock held.

If you were to buy this stock today, you would have to pay ca £104 for every £100 of stock purchased. The fixed yield on your initial investment is 5%pa. This enables you to lock into levels of interest which you might not get next year.

Another asset class I favour at the moment is gold. Gold is the ultimate hedge against difficult times and currency concerns. It has climbed steeply from a low of $220 per oz (about the time Gordon Brown sold half the UK reserves) to just over $1,000 in March 2008. As recently as mid August it was below $800 but climbed by 8% in one day when the first bail-out plan was rejected. Not for the feint hearted!

However, the place to invest for the future is Asia, including Japan. These countries haven't suffered the credit crunch to the extent of the west, they have a growing middle class, a need for infrastructure and low indebtedness in society. Over the next 6-9 months I will be searching for investments that will give the best exposure to this. Then the strategy should be to build up though monthly purchases of shares / units to a proportion of your portfolio you feel comfortable you can sustain.

What of commodity and emerging market funds? These have been some of the best performers of the last three years but now their bubble has burst. Provided they constitute no more than 3% of your total portfolio I consider it is best to hold on because they will recover.

In the meantime, the best thing to do is to batten down the hatches, make sure you are happy to accept the level of volatility you're exposed to and wait!

Martec Associates

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