FPC COMMENT – One year on…

In late November 2008, in the wake of the bankruptcy of Lehman Brothers, the world's financial system was in meltdown. In Britain: banks failed, house prices crashed, interest rates plummeted, Sterling collapsed (£1.00 traded as low as $1.35, down from $2.11) and the stock market shed billions daily as investors panicked.

In late November 2009, the UK is bogged down by recessionary pressures. The economy is struggling, interest rates are now near-zero and unemployment is up. However, some optimism has returned to the stock market, which is trading over 50% higher than in early March.

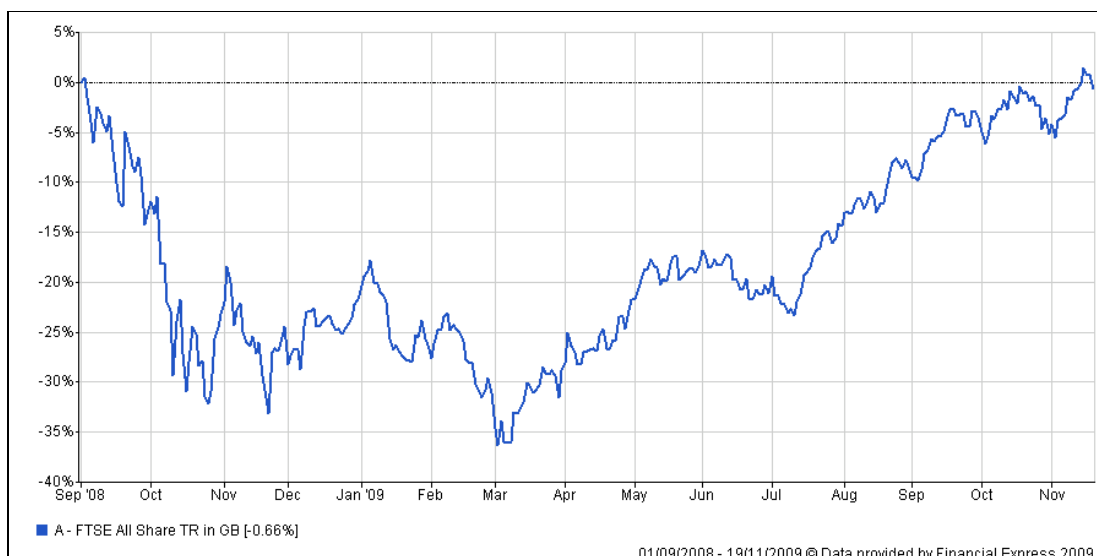
Is it too soon to see "green shoots of recovery" in the economy?
What can we do to secure financial independence when the future looks so uncertain?

Equities

Global stock markets, with one or two notable exceptions, have performed extremely well in the past six months. In most cases, the rally (in local currency) has been in excess of 50%. However, we do not believe that this necessarily points to recovery:

> *The relief of having 'Armageddon' taken off the table meant that risk assets, trading on valuations not seen for 2-3 generations, quite rationally massively re-valued in response to the reduction in risk.*
>
> ***Martin Brookes (Director of Portfolio Management, Prudential)***

We absolutely concur with Martin's analysis. For example, consider the performance (total return) of the FTSE All Share index, from last September:



We have essentially returned to the world of a year ago, before the collapse of Lehman Brothers.

Whilst this does not mean that the rally is insignificant, it does suggest that recovery is another matter entirely. We feel that the global economy has – on the balance of probability – turned a corner; however, we also feel that future growth is likely to be constrained as businesses and consumers focus on balance sheet repair, rather than credit-fuelled expansion or spending.

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Bonds

Corporate bonds (particularly higher-yielding, lower-rated stocks) have performed extraordinarily well since early April 2009, delivering 'equity-like' returns to investors. However, this is largely the result of the perceived risks of default reducing and reflects short term money returning to the market. The doomsday scenario we faced at the beginning of the year has now been replaced with a more 'typical' recession scenario.

Paul Reed, Co-Head of Fixed Interest at Invesco Perpetual, believes that bonds will offer investors 'bond-like' returns, with lower levels of volatility than in the past year. We share this view. Interest rates are at historically low levels and the consensus estimate is that rates will remain low well into 2011. However, in order to obtain finance in the absence of bank lending, many major companies have to issue bonds with (relatively) high yields.

In the current economic climate, the potential for Corporate Bonds to generate income within a balanced portfolio is very attractive; now that we are out of the "perfect storm" we have just weathered, they should once again act as a useful hedge against the more volatile equity market.

Property

Commercial property valuations in the UK are down 40% from their peak in mid-2007; however, the IPD Monthly Index has registered a positive return for the last two data points (July and August), perhaps indicating that the market has finally bottomed.

Although rental yields currently look attractive, particularly in the context of historically low interest rates, we remain cautious and do not recommend allocating funds to property just yet.

The sector remains vulnerable in fragile economic conditions: there is significant refinancing and tenancy risk, whilst capital growth is likely to be anaemic. We will continue to monitor the situation closely and revise our tactical stance only when conditions have markedly improved: there seems little short-term benefit in rushing to invest.

Inflation... or deflation?

Both inflationary and deflationary pressures exist in the economy at present:

- Bank of England's policy of 'Quantitative Easing' (inflationary),
- Historically low interest rates (inflationary),

- Severe contraction in business and consumer credit (deflationary),
- Significant unused industrial capacity, e.g. a large output gap (deflationary),
- Very high and rising unemployment (deflationary),

Richard Woolnough, who has successfully managed the **M&G Corporate Bond fund** for many years, believes that we might experience either outcome; it is impossible to predict with any certainty, as the full impact of QE is yet to be felt. The Invesco Perpetual house view is that deflation is the more probable outcome, as businesses and consumers choose to pay down debts in a process of deleveraging across the economy.

Andrew Milligan of **Standard Life** predicts an *"upturn in headline inflation into 2010"*, yet warns that *"investors should be wary of strong underlying disinflation"*. He predicts further volatility until the labour markets begin to normalise and risks of policy errors (fiscal / monetary policy; QE) decline, whilst highlighting the likely variability of outcomes in different countries.

Our view

Over the last six months we have witnessed a welcome recovery in equity and fixed interest markets and this has had a positive impact on all of our clients' investments. However, we remain cautious.

'With Profits' funds such as the Prudential's have seen a significant reduction or in some cases a complete removal of market value adjustments. We support the recent stance taken by Martin Brookes to de-risk the fund still further and consolidate gains made.

Within the pension funds, trust funds, investment bonds and personal portfolios that we supervise, similar gains have been experienced. We are happy with our overall asset allocation stance, which reflects both UK and overseas exposure and incorporates not only corporate bonds but also government fixed interest and index linked stocks.

Over the last 18 months our investment stance has been truly tested but we believe that the core principles we adopt have served our clients well and are now more relevant than ever in these tough times.

Separate savings and investments

Unprecedented volatility in the markets over the past 18 months has once again demonstrated the necessity of keeping a solid cash reserve, to meet all spending commitments and for peace of mind. The fact that we retained targeted cash reserves in all pension funds we supervise has meant that income has been protected. We have maintained this stance for all clients in income drawdown (unsecured pensions).

Remember: in the long-term, markets are always likely to recover – but investment portfolios sold in distressed conditions are not!

Reduce investment risks through asset allocation and diversification strategies

Longer-term investment is vital, however, to protect capital from inflation and to provide a future income.

Research has shown that asset allocation is the key determinant of long-term portfolio performance. Hence, it is the recipe (asset allocation) that makes for a successful outcome – great ingredients are not enough.

Our approach adopts this key principle and has shown that a diversified investment strategy combining different asset classes together can be invaluable in reducing the overall risk associated with an investment portfolio, whilst targeting a set return. Limiting exposure to individual regions and sectors also has the effect of reducing volatility.

So: is now a good time to invest?

The answer is yes, but in reality there is no bad time to invest provided your investment timescale and risk profile are reflected in what you do. Try and avoid falling victim to the latest flavour of the month and watch out for the 'too good to be true' products on offer – it is those who tried to time markets, hopping from one over-hyped sector to the next, who have suffered the most in recent years.

Stick with a proven strategy and you will not be disappointed.

We hope that you have found this commentary useful. As always, should you require any further clarification or explanation, or if you need further investment advice do not hesitate to contact a member of the advisory team.

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