



2007 and 2008 to date

The UK economy seems to be in some difficulty, June was a rotten month for equities and the papers are predicting all sorts of ghastly outcomes. In this note I will look at whether there are any historical precedents for the sort of difficulties we are currently experiencing.

In 2007 most international indices were fairly flat. To 1 September 2008 most indices are well down on their 1 January position. We continue to recommend an emphasis towards value strategies and small companies strategies. These strategies have underperformed the broader markets.

There is a lot of doom and gloom around. In June I saw predictions for the FTSE 100 of just above 5,000 by year end, headlines proclaiming "worst slump for 30 years" and predictions that equity returns will continue to be poor as far as we can see into the future. In August I have seen two reputable fund managers predict FTSE 100 levels of 3,000 prior to a recovery.



As you know, we do not believe that it is possible to time the market in a way that produces material net gains for investors. That is, we do not believe it is generally profitable to try and anticipate the direction that the markets are going to move and to buy or sell based on that prediction. We are not in a position to advise whether this is the right time to get back into the market (a question posed again by the Sunday Times recently). Even if such behaviour is theoretically possible, in practice the transactional costs and the occasional missed opportunity means that timing the market is, at absolute best, a high risk strategy unsuitable for our wealth management clients.

We are in the business of helping clients to decide what to do with their portfolios. The overwhelming urge is that during difficult times one should at least do something. The comfort that comes from taking action is real – those that have studied behavioural finance have lots to say about this compulsion to take action. Journalists support this emotion – "buy cyclical stocks", "don't miss the flight to quality" and "10 stocks that will perform in a recession" are all better headlines than "stay invested".

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Our experience is that emotional reactions are the enemy of successful investing. We would rather base our advice and actions on research and analysis. There are many studies of bad investment times and what has happened to stock market returns during these times. Fundamentally investment in equities over the long term produces a higher return than the risk free rate of return (deposit accounts) because investors demand a premium over and above the risk free rate. There is compelling evidence that over the very long term investors in value companies and small companies receive a return higher than that paid to the broad equity market.

It is relevant to examine what happens to these premia during times when the economy is apparently weak. In general, during the good times, people are willing to take risks. Employment or self employment feels secure, incomes are rising steadily, GDP is growing and so it feels fine to purchase a buy to let, or expand a business, or invest a little more in volatile assets. However during bad times this picture reverses and people become unwilling to take risks. There is often a rush to invest in low risk assets; sometimes labelled as a flight to quality. In these circumstances risk premia are not high enough for investors to invest in risky assets. Therefore during bad economic times risk premia should increase.



The (stock) market compensates investors for taking risk. The terms “expected return” and “expected risk premium” are carefully defined terms in financial economics. It is a little bit boring but the thing to remember is that if an asset has an expected return of 10% per annum you cannot be surprised if it returns a number different from 10%.

During times when the economy is weak, risk and expected risk are both higher than during more normal times. Several studies reach this conclusion:-

“Expected returns on bonds and stocks are lower when economic conditions are strong and higher when conditions are weak”

Fama and French, 1989, Journal of Financial Economics

The risk premium is expected to be countercyclical: lower in good times and higher in bad times.

Campbell and Cochrane, 1999, *Journal of Political Economy*

The risk of value stocks is greater and the price of risk increases during bad economic times.

Lettau and Ludvigson, 2001, Journal of Political Economy

Petkova and Zhang, 2005, Journal of Financial Economics

There is a mass of data to consider. If you are interested to see some more data then please give me a call. The conclusions of the papers that we are convinced by are as follows:-

Risk premia are compensation for taking risk.

During times of weak economic conditions the relationship between risk and reward holds up well. Those investors who are willing to invest during these times ultimately reap a higher reward than those that wait until good times return.

It is almost impossible to identify peaks and troughs in markets or assets in advance.

Expected risk premia should increase in bad times.

There is no evidence that realised premia become reliably negative during a recession.

How does this boil down to action? We run multi asset portfolios. Nearly all clients have exposure to a wide range of asset classes. The stockholdings are diversified by size, book to market ratio and internationally. We continue to encourage clients who are due to rebalance their portfolios to take profits and to use these profits to purchase assets that are temporarily underperforming. So recently clients that are rebalancing their portfolios are purchasing small and value stocks.

If you would like further information on any of the issues discussed please contact Ben Sherwood on 01442 220713 or email ben.sherwood@hllp.co.uk.

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