



Equities, outflows and when to move to cash

The period to the end of 2007 was another volatile quarter for equities. The UK All Share was approximately 1% down to 31 December and has since fallen by a further 10%. Most of our clients' portfolios have a tilt towards smaller companies. Smaller companies underperformed the main market returning approximately -6% over the quarter to 31 December.

The broadsheets from the end of December talk about the possibility of future recession and how investors should adjust their portfolios to deal with the credit crunch / US recession / falling interest rates. I think however the bigger story is what retail investors have actually been doing over the last few months.

In November investors withdrew more money from unit trusts and OEICs than they invested. Investment companies suffered net withdrawals. This is unusual; we need to look back to 1992 to find the last time this happened. £606 million flowed out of equity and commercial property funds in November 2007. In January equity and property funds had net out flows of £867 million. So in the face of this very marked selling by retail investors what actions should prudent academic investors take?

Hillier Hopkins have not recommended any significant changes to our clients' portfolios. We have neither moved generally out of equities nor specifically from small companies to main market. Here are the reasons:

- 1) We cannot find evidence that this tactical approach to investing provides reliable net returns for retail investors. We can find a great deal of evidence that tactical asset allocation (moving from one asset class to another as a reaction to economic news, sentiment and perceived future short term returns) *reduces* returns for clients over the longer term.
- 2) Although we access exceptionally competitive dealing terms for our clients there is always some frictional cost in switching investments, even if it is not explicitly stated. These costs mount quickly if a tactical approach is adopted and further reduce returns.

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3) Our clients are long-term investors who understand the risks of investing in equities. They know that volatility is a necessary price that investors pay for the prospect of superior long-term returns. If providing capital for businesses was a one way bet the market would briskly arbitrage out any return over and above the risk free rate of return. Our clients know that on average UK and US markets are volatile and move in unpredictable lurches – in an average calendar year equities will only significantly outperform cash in one quarter out of four. There are sustained periods where markets do not conform to this average – they may over or under perform other asset classes for much longer periods of time. But in the long- term our clients are confident of receiving a premium over and above the risk free rate in exchange for providing capital to businesses where there are all manner of risks.

4) Emotion is one of the enemies of successful investment for most of us. If equities decline it is tempting to sell. There is good evidence that retail investors (speculators really) earn far lower returns than those available even from average actively managed funds. This is because retail investors often sell on market losses and are then not in the market for the usually unexpected and sharp rise that eventually materialises. Who is in the market for these rises? Generally, you will not find the long-term investors and institutions engaged in these panic selling tactics. They will just stay invested exactly as we recommend to our investors. Indeed if there is a very marked decline in equities while other assets are performing well, we will recommend that clients buy more equities, not sell.

5) Our clients appreciate that investments in smaller companies have a higher expected return than investments in larger companies. There are protracted periods where this excess return is not delivered, but eventually we expect to see this excess return paid to investors. Detailed academic studies over many periods using very carefully scrutinized data shows that the small companies premium does exist and exists consistently.

6) Our clients have diversified portfolios and have enough cash to meet short-term requirements. The diversification means that their portfolios as a whole rarely suffer the full loss associated with severe equity downturns. The cash position means that they should never be forced sellers.

Watching a portfolio decline in value is never an enjoyable experience. However clients understand that these declines and volatility are a necessary price to pay for the likelihood of medium or long-term portfolio success.

We continue to remain calm and do not recommend any big moves in our clients' portfolios.

The above article quickly covers a number of important points. If you would like to discuss any of them in further detail please do not hesitate to contact Ben Sherwood or your normal Hillier Hopkins contact.

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