Happy New Year

(And more on why we do not do much short term forecasting)

I hope that you all had a peaceful time over Christmas and New Year. This is traditionally the time to look back at the previous twelve months and look forward to the next twelve. As virtually all readers will know, I do not think that this sort of stargazing is generally very useful or reliable as a guide to investment actions that clients should consider now.

But it can be good fun to look back and to talk about the future. These are our thoughts:

2007 was the year when credit markets suffered a real jolt, and this has in turn knocked worldwide equity markets so hard that the reverberations are not over by a long way. Investment performance of the main asset classes in general has been between mediocre and poor. The financial alchemy that created high quality securities out of low quality securities was exposed and market participants rushed to reprice these securities. However, actually pricing these securities proved rather tricky since it was rather difficult to work out in these pre and re packaged securities where the bad debts actually were, or are (for those who would like a more detailed discussion of this topic, Robert Peston, the BBC business editor, and Philip Coggan, now with the Economist, wrote lots of good copy on this subject). The key lesson I think is to continue to listen to Warren Buffet – his pithy quotes are good fun, but one of his key messages is that he will not buy investments he does not understand. He first gave this simple guidance to his shareholders in 1977 and it should never be forgotten.

Other Warren Buffet quotations:

> “Risk comes from not knowing what you are doing”

> “I violated the Noah rule: Predicting rain doesn’t count, building arks does”

and on gold….

> “It gets dug out of the ground in Africa, or someplace. Then we melt it down, dig another hole, bury it again and pay people to stand around guarding it. It has no utility. Anyone watching from Mars would be scratching their head."

Back to 2007. Now it all seems so predictable. Repackaged and complex US securities were bought and traded by major banks as well as the hedge funds that suffered both heavy criticism and heavy losses. Quite suddenly the market decided that these securities were very overvalued and the London interbank rate (LIBOR) quickly spiralled.

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Northern Rock ran into serious trouble since it could not refinance its long term lending with short term financing and pretty much every reader is currently subsidising that organisation's rescue. Two regulatory matters were bought into focus by the events covered in this paragraph. 1) The dubious practice where businesses pay a credit rating agency to give that business a credit rating. Does this not seem intrinsically odd to you? And 2) The failure of the new regulatory system with the FSA, Bank of England and Treasury playing pass the buck at lightning speed. Do not forget we have had plenty of other banking crises before when the Bank of England took the lead. Of course there were some horribly painful outcomes but one has to go centuries back to find a run on a bank a la Northern Rock.

Given all of the above it seems that the UK equity market has been pretty resilient. I know the net result (main market just about level, small and value stocks a few per cent down) is poor but we have had collaterised debt obligations exposed as misunderstood and mispriced, hedge funds suffering huge losses, international banks refusing to lend to each other, a run on a major UK bank… and the stockmarket at the time of writing is roughly where it was at the start of 2007.

We are certainly not out of the woods yet. Even if the Bank of England and other central banks cut interest rates this does not automatically increase the supply of credit. If banks rein in their lending to consumers and businesses it is hard to see how this is positive in the short term for equities and property.

Commercial property has suffered considerably and several fund houses have started to invoke temporary moratoriums on redemptions from these funds. As we point out regularly, the valuation of property until it is sold is a matter of opinion. The valuations of open ended funds such as unit trusts will tend to lag the market. However, the valuers when they do come up with a figure have a tough call to make since activity in many areas of the commercial property market is well down compared to 12 months ago; if there are few similar transactions to reference it is not easy for the valuer to come up with any figure.

The only sector that really did very well was Emerging Markets, which is up 30% or more depending on definitions. Our clients only have a small exposure to this asset class (6% is typical) but it was good to see a nicely non-correlated asset.

Turning to 2008…

Forecasting short term asset returns is desperately difficult. Buffet again:

> "In the business world, the rear view mirror is always clearer than the windscreen"

Our position is more radical than this. Predicting short term moves is difficult enough for us to conclude that we cannot anticipate with any statistical significance who is going to make predictions that are better than the market predictions; if we cannot do this then lets not waste time, effort and money trying to do so. Instead looking scientifically at data covering longer time periods helps to inform our recommendations.

We can say with some certainty that this is unlikely to be a smooth year. This is not because we are clever, it is because most years are not smooth. Inflation is set to become a worry both in the UK and further afield; interest rates may not be as effective at controlling inflation as they appear to have been over the last five years; the oil price is rising to historical highs, there is political uncertainty in Africa and further afield and personal and corporate debt continues its apparently inexorable rise.

Our role is not to predict how these key themes will affect asset prices. Our role is to ensure that each wealth management client is as well positioned as he or she can be to deal with the various possible outcomes. Being well positioned means more than having investments in an intelligent place, though this is obviously crucial. We work to ensure that, where possible, contingencies are insured or separately funded and that a portfolio is diversified enough such that any one down turn or disaster does not put a clients' financial well being at risk. All actions and plans should be made with their tax consequences in mind. Finally being well positioned means feeling confident, secure and relaxed about the various building blocks that make up an individual's wealth.

In 2008 we expect stockmarkets to rise generally. This is because generally stockmarkets rise. Authoritative commentators normally publish their predictions at this time of year. I have looked at these predictions for years – I cannot find anyone who is materially better than average. Last week's Sunday Times published estimates from 10 global companies – serious companies like UBS and Goldman Sachs.

The average prediction is for the market to grow by 1%. Highest prediction was +11% and lowest was – 9%. This is an unusually large range and an unusually low average but even so I think a cursory glance at the data tells us more. In the last ten years the UK market has only produced a single digit capital return in three years (2000, 2004 and 2007). In the other seven years investors have either made or lost more than 10%. However, very few commentators make any double digit predictions, despite the fact that over the last ten (and twenty) year periods double digit returns have occurred roughly 80% of the time (the exact answer depends on how you measure the market, treat costs, dividends and so on).

There are many reasons for this reluctance to forecast double-digit numbers including peer pressure and job retention pressure. But what would it mean if any of these huge global houses thought that the UK market was going to rise or fall by more than 10%? Surely they would take action with their own money and their clients' money?

The truth is of course that the ability to predict year to year returns is a skill that is impossible or hard to find. If someone or some group of individuals has this information, what on earth would be their incentive for sharing the information? Commentators do not know what is going to happen and even our educated guesses are often wrong. In the long run the total return on equities is likely to be Retail Price Inflation plus 4% or 5% before tax and charges. The annual standard deviation is high. Dangers for 2008 include US profitability and inflation throughout the developed world. That is a specific as I wish to be on predictions.

The actions that you can take as a result of these predictions are to review your portfolio and ensure that it is diversified by geography, sector and type of company and asset class. Hold onto index linked gilts as an insurance against inflation. Do not buy substandard company bonds – the market does not reward you sufficiently for the risks you will take.

If you would like to gamble for fun rather than as part of serious wealth management, purchase a few shares in any geared closed end vehicle that purchases property. Property is unlike any other asset – it is heterogeneous and transaction costs are very high compared to other asset classes. This means the market is more imperfect than the other asset classes. These vehicles are apparently trading at big discounts to underlying value, but as covered above – what on earth is the value?

What else could be considered at this time of year?

How about revisiting tax planning?

Due consideration of tax planning of course forms part of the annual review meeting for most clients but if you would like to discuss any of the following before your next review then do not hesitate to contact me or your usual Hillier Hopkins contact.

1) Are there any tax advantaged investments that you might like to consider before 5 April? (We have already written to all wealth management clients about ISAs).

2) Consider investing in a portfolio of high risk AIM shares that can qualify for a favourable inheritance tax treatment after just two years.

3) Is this the right moment to consider gifting assets to other family members to try and reduce the family's overall tax liability?

4) If you have suffered Capital Gains Tax at 40% in 2007/08 it may well be worth considering investment into a scheme that defers that tax and reduces income tax

5) Some types of trust were granted a window until April 2008 during which time the trustees can take action to reduce future taxation liabilities. Do you have such a trust and have you reviewed it?

6) Would you like to consider gifting assets to a trust? After seven years and subject to some conditions they will be outside of your estate after seven years for inheritance tax purposes

7) If you are considering disposing of any asset the new CGT rules are almost certain to affect you.

8) Pension contributions will generally attract relief at your highest marginal rate. In most cases pensions can be cashed in a few days after investment at which point 25% of the total fund is available free of tax, the remainder of the fund is used to pay a pension.

If any of the above might be of interest do not hesitate to contact me

Ben Sherwood - Principal
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