

Money markets, banking, 1974, wealth management – help.

As I said in my recent bulletin, we live in historic times. Those of us who rely on an investment portfolio to deliver certain key payments cannot help but glance at the headlines. While the details are complex and the government policy decisions horribly taxing in every way, the basics are not complicated:-

- 1) We are in the middle of a money market crisis. This is driven by the realisation that assets owned by banks can be tricky to value when no one is willing or able to buy the assets. The solutions will centre around liquidity and confidence.
- 2) The US and UK housing markets are in trouble. The supply of mortgages has reduced and so the price has risen. Consumers do not like sharply falling house prices and expensive mortgages.

How governments, individuals and businesses react to these fundamentals is not easy to predict. The overwhelming consensus is that the UK economy and the participants in that economy are in for a rough time. A recession looks inevitable. The mistake is to assume that recession = poor stockmarket returns. I wrote about this in one of the articles that went out with your last valuation. There is no evidence that the realised premia for investment in stocks vs the risk free rate are reliably negative during recessions. Indeed the expected return rises during times of uncertainty as investors demand higher returns. Of course one way of reaching higher returns for newer investors is for capital values to be forced down, but this is not the only way to achieve the required return.

One of the headlines that comes up at times like this is “Sellers forced the value of the stockmarket down” which is barely OK or “Sellers hugely outnumbered buyers and values were pushed down” which is very questionable. The point is that there are always the same number of shares bought as are sold – how could it be any other way? What happens at times such as these is that sellers are unable to achieve the prices they initially seek and so can react in one of two ways:-

- 1) Decide not to sell

or

- 2) Reduce the price at which they are willing to sell.

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When sellers take course of action 2) shares are bought and sold. But the price on any one day or any one deal does not stay the same. There are myriad influences on the prices of stocks and shares – maybe a company recruits a star senior director, maybe the cost of raw materials reduces, maybe a new political decision somehow assists a company, maybe a buyer's expectation of future market growth changes, maybe a seller's expectation of a company's future liabilities changes; there are hundreds of maybes. But these maybes all affect the price at which the seller is happy to sell and the buyer happy to buy. So the concept that markets are balanced stable animals is silly. They are the reverse – they are touchy volatile animals that move through a never ending journey that is plotted by a series of momentary equilibriums when buyer and seller are both happy.

This huge volume of information and the many different interpretations of that information are part of the reason that picking stocks and timing markets are so incredibly difficult to do successfully.

But there are some encouraging points that can be pulled from continued examination of markets. A lot of the "maybes" are confusing and extraneous – their effect on the value of the asset might be extreme but will also be short lived. Some assets display consistent trends when examined over long time frames.

One of these trends is that in a capitalist market there is a return on capital. If there were no long term return on capital then those with capital would not invest and capitalism would be in serious trouble.

Also as mentioned above, when share values fall relative to a company's "fundamental" value, the company's cost of capital has just gone up. In other words the investor is being offered a higher expected rate of return than before the share value dropped.

There are still plenty of individuals buying stocks and shares. Stay invested, stay diversified, ensure that you are never a forced seller.

Ben Sherwood

Principal

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