



## Out of the woods?

The quarter's equity performance figures look between OK and spectacular if given a cursory glance. The phrase of the moment seems to be "increased appetite for risk" and the weekend papers, though still more confused than ever, are printing plenty of stories about "how to benefit from the upturn" or "experts tip best equity funds". As usual these big mood swings between boundless optimism and deep pessimism are unjustified.

There remains much to be cautious of – the quarter's stockmarket results disguise a small fall in June and a record equalling July followed by a superb August. The Office for National Statistics advises that the UK economy contracted by 2.4% during January to March 2009; this is the largest decline in 51 years and was much worse than the forecast of approximately 1.9%. From April to June the economy shrank by a further 0.8% (since revised to 0.7%). Although this is in a mathematical sense an improvement, it is again a greater fall than economists predicted. The Society of Motor Manufacturers and Traders (SMMT) advised that May's new car sales were 25% down on the same period in 2008 and that car production fell by 43%. Indeed UK car sales in July increased for the first time since April but car sales for the year are still down 22.8%. And still more recent anecdotal evidence suggests that some manufacturers are running out of stock! The scrappage scheme seems to have worked to some extent.

These depressing and confused snippets of information are not the statistics I would expect to be browsing through if our servants Messrs Brown and Darling had successfully nurtured the green shoots of recovery that commentators now seem to be seeing.

I am not asking you to be negative or downbeat about the future. I just wish that commentators would not swing so wildly from telling us one day that capitalism might be dead to a couple of weeks later exalting us to move all cash into stocks. In fact, as is often the case, the truth is in the middle. There is still very substantial volatility and there are all sorts of good reasons to be scared and at the core of that concern is government debt. But it is also true that in the very long term it seems that stocks do provide a better return than other mainstream assets and do exhibit some trend to revert to their mean return.

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There is also the slightly dangerous argument that has its premise in “where else can I put my money”? Conventional gilts are yielding less than 3% (after taking into account the guaranteed capital loss) until past 2014, property seems illiquid, deposit accounts pay between 0% and 4% but (UK) equities offer a yield of over 4% and the prospect of capital growth.

My suggestion is that we retreat to academic evidence. Historically investment into equities has largely worked over the medium term. There have been some dreadful periods when it has felt as though the world has altered beyond recognition and there are a couple of papers currently doing the rounds suggesting that “The Equity Cult is Dead” or similar; but a review of the performance of major markets over the last 50 or 100 years suggests to me that historically equities have produced a return higher than the risk free rate of return. In other words investors have been paid a premium (a risk premium) for investing in something with a less certain outcome than buying a gilt. And of course in order to receive that premium there must be a real risk involved in holding the asset.

This crisis is different from the last crisis. And every new crisis will be unique. If this were not the case they would not crop up in the first place. However, we may be able to learn something about how we should react to the current crisis by looking at other crises that had some similarities with the current one. Inmoo Lee, PhD of DFA produced a paper with Garrett Quigley that looked at the following four crises:-

The Asian Financial Crisis of 1997

The Japanese Financial Crisis in the mid to late 1990s

The UK Secondary Banking Crisis of 1973/4

The Swedish Banking Crises of the early 1990s

If you would like a copy of the presentation please contact me. It contains interesting data and detail.

These four crises were very different from each other in many ways. The paper then goes on to look at the implications for equity markets of these crises. My précis of the authors' conclusions is as follows:-

1. There are some common factors – immediately prior to the crises asset values had risen sharply as had leverage. When the leverage providers got into difficulties it had a huge knock on effect in many areas of the economy and asset values and stockmarkets suffered significantly.
2. When the recovery arrived, stock market returns were very high and were delivered very quickly.
3. The time until recovery (the time in the trough) is very hard to predict in advance.

This then ties in with an earlier note I sent round. At times of unusually great uncertainty, risk premiums *rise* – the expected return rises. There is never any guarantee that the expected return will be delivered but experience suggests that, eventually, it is delivered.

My overall conclusion is to suggest that what matters is peace of mind. Quite often in financial terms this means having sufficient cashflow. Moving from one financial column to another will not provide any peace of mind – it will merely produce more anxiety. There is more than enough to be anxious about without any help from the media – the world is in the middle of a financial crisis that is extremely severe and we are far from out of the woods.

Informed investors who have sufficient cashflow to enable them to meet all their requirements can draw some reassurance from other financial crises. In the past the troughs have been practically impossible to predict but the recovery, when it arrives, has been dramatic.

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