INDEPENDENT FINANCIAL ADVISERS

Investments & Pensions

Mortgages & Insurance

Investment Review: July 2008

~ STRAIGHTFORWARD ADVICE..... IN BLACK AND WHITE ~

About Hurst Financial Consultancy

Hurst Financial Consultancy was founded in 1997 by the Managing Director, Michael Hurst. The company has operated successfully in Salisbury from inception serving clients locally, nationally and internationally.

The company focus has always been on excellence.

We have also developed a strong focus on state of the art information technology being aware of its significant value in not only collating data, but managing the performance of investments. We have our own in-house IT department and use its services constantly to develop the service that we give to our clients to ensure it is always “leading edge”.

As Independent Financial Advisers we have access to the full range of products and services available in the UK as opposed to a Tied Agent or Company Representative who may only advise and offer products from the company they represent. This means that we are able to give you impartial advice and recommend the most appropriate products for you, so that you will enjoy choice, value for money and our high-quality service.

Positive Messages

This has been without doubt a very troubled period now that has extended for 12 months in investment markets. It is important that we remain calm and keep on our professional heads about investing and do not become so overwhelmed so as to make classic investment errors – selling when markets are down, buying when they are up.

This is a familiar theme that rides through our Investment Reports – this months report will look at the views of some of the UK's foremost investment managers and aims to re-assure all of us as to outlook and in some instances timescale.

What we do need to remember also is that: markets going down in value is normal – they always do this and they do always go back up.

Words from the wise

Sir John Marks Templeton died early in July 2008 at the age of 95 – he conquered Wall Street to become one of the world's greatest investors and philanthropists. Renowned for his pithy aphorisms, Sir John had a simple philosophy: "If 90 per cent of people are selling something it is probably undervalued; look in countries where other people aren't looking; and do the opposite of others". He founded one of the first mutual funds in 1954 and on his retirement in 1992 that fund had annualised returns of 15%. A shrewd investor, he famously bought equities the day after the 1987 stock market crash. His best known saying is probably: "Bull markets are born on pessimism, mature on optimism and die on euphoria. The time of maximum pessimism is the best time to buy and the time of maximum optimism is the best time to sell".

Another great investor, now retired from running the Fidelity Special Situations fund, is Anthony Bolton who, writing in **The Sunday Telegraph**, shared his thoughts as to what advice he might give private investors. "These are my personal views. My recommendation is not to attempt to time the markets but to take a long-term view. History has shown us that the patient investor has been rewarded by the long-term uptrend. Trying to switch in and out of the stock market is very difficult and most investors who try it are worse off as a result. Our research shows that £1,000 invested 15 years ago would be worth £3,261 today if left untouched. Had you missed the best 10 days it would be worth £2,147 and only £885 if you had missed the best 40 days. You mustn't get bearish as the market falls. At the bottom of the market the outlook will appear worst of all. This is when the pressure is greatest – the point of maximum capitulation – and you may feel like quitting equity investment for good". A useful reminder for anyone during these difficult times.

One of the UK's most successful investment professionals is Neil Woodford of Invesco Perpetual, who is well known for his cautious outlook for the UK economy and which has been reflected in his more defensively positioned portfolio. "Against this very difficult backdrop there is fortunately a silver lining in my opinion. This is absolutely the wrong time to despair and sell equities. For various reasons institutional investors, such as pension funds, are selling their equities, just like they did back in 2001-02 and again at the wrong time. UK equities are the cheapest asset class compared to fixed-interest and property – even cash because this will not be inflation-proofed – and against European equities too. So this is a great time to invest although it may not seem like it. I know that in three to five years time we will have made a lot of money, so people should not get out of equities now – it would be the worst possible time. You only need to look at the facts to support my views and the long-term case. Back in the 1960's, equities used to yield more than bonds [fixed-interest] because of the risk element but then there was a cross-over and equities yielded less than bonds. Today we have a situation where many stocks yield more than Government stock - for example BP yields 5% [net] and trades on a price-earnings ratio of six (which is very low) yet its profits are going up. The market is taking a very pessimistic view short-term, but my experience tells me that when equities feel awful you should buy".

So here we have the views of three very well known experts whose views hopefully will serve as some re-assurance to our own much repeated 'mantra' to be brave and sit tight.

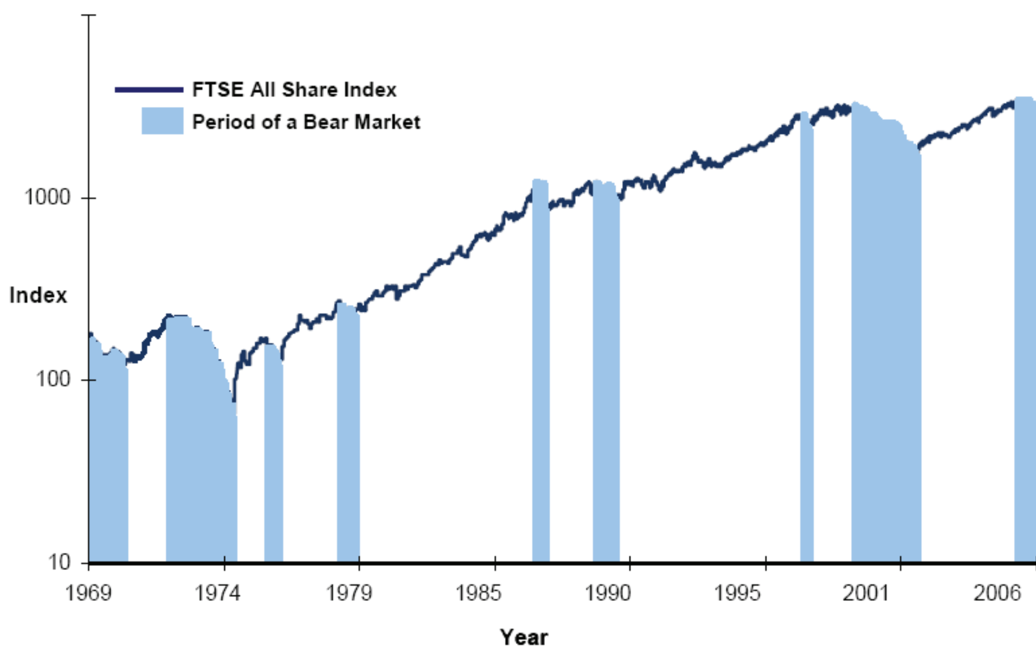
OPPORTUNITIES IN A BEAR MARKET AND RECESSION

A difficult start to 2008 is generating opportunities

The turbulence in financial markets, which started last summer, has shown few signs of abating. Problems which were initially centred on US sub-prime mortgage markets have spread to the financial sector, equity markets and the real economy.

So far 2008 has been a roller coaster for both fund managers and investors. Equity markets have been extremely volatile. Since reaching a peak of 6732 in June 2007, the FTSE 100 had fallen 19% by March 2008. It then rose 18% by mid May but had dipped below 5450 in early July, again down by over 19% since last year's peak.

Indeed if, according to many commentators, an equity bear market is defined as a 20% drop in the level of the stock market, we have just seen the ninth such UK bear market in the last 40 years based on the FTSE All Share index. These turbulent conditions are now spreading to the real economy, most notably the tightening in credit conditions. This has resulted in a mortgage famine in the UK causing the number of both commercial and residential property transactions to fall, impacting property values.



Under these circumstances it is easy to dismiss equity and fixed income investment, but on closer inspection there are a number of sectors that have performed well and have in fact made significant gains in 2008 to support the wider market. In addition, the continuing indiscriminate, and in some cases extreme, sell-off in various sectors of the market means that there will be many companies and sectors trading at valuations which should be considered very attractive, especially when judged on a three to five year investment time horizon. As can be seen from the graph above, bear markets are a fairly regular interruption to the general upward market and investors with a long time horizon can benefit from the opportunities they present.

The anticipation of recession often depresses stock markets

The FTSE All Share Index, reflecting the performance of the overall UK equity market, shows nine bear markets since daily calculations began in 1969. The most recent one can be dated from the peak of the market, 3,478.99 on 15 June 2007, to the most recent low point of 2,777.55 on 17 March 2008 (based on data to 30 June 2008) - a 20.2% fall which may not yet be over.

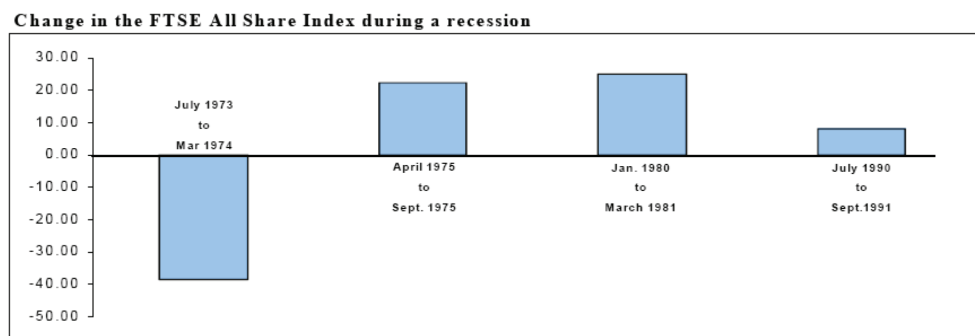
Of the nine bear markets, there were six quite short ones, lasting a year or less, and three lasting over a year. The most recent bear market lasted over 30 months from September 2000 to March 2003. The economic and financial market characteristics of each of these varied enormously. That said, the current seems to share the characteristics of the short, sharp bear markets of 1987 and 1998 and that of the early 1990s. Turbulence in 1987 and 1998 centred on financial sector triggers, the stock market crash on Black Monday, 19 October 1987, and Russia's default and the collapse of Long Term Capital Management (LTCM – a hedge fund) in 1998. In the early 1990s the housing market was particularly weak, triggering a bear market of similar magnitude but shorter in duration.

The behaviour of equity markets is often cited as a leading indicator of economies. In particular, weakness in the equity market is thought to signal the likelihood of a recession. This is not necessarily true, the imperfect linkage between the stock market and the economy has long been recognised by economists, with nine bear markets in the last 40 years, but only four recessions (defined as periods in which GDP has fallen by two or more consecutive quarters). Moreover, recent history shows that it's often the anticipation of a recession that depresses stock markets, not the other way round.

Taking advantage of the relationship between markets and recessions

Some economists believe that parts of the global economy are already in a recession, the US being a prime example, but if history tells us anything this may be positive for equity markets. In three of the last four US recessions, stocks actually gained ground. In the US recession from July 1990 to March 1991, for instance, the S&P 500 rose 4.5%, despite a severe sell-off in the summer of 1990. And in the recession from January to July of 1980, stocks climbed 6%.

Typically, US equities have tended to rebound or maintain momentum as the US economy emerges from a recession. Ned Davis Research in the USA looked at the last 10 recessions and found that stocks rose 24% on average, in the six months after hitting a recession low. Tim Hayes, Chief Investment Strategist at Ned Davis, said that while a recession could continue to pressure the stock market, "it could also lead to a great buying opportunity."



Data Source: Lipper. All periods from start of initial month to end of final month.

Similarly in the UK, recessions are not necessarily bad for equity markets. Indeed, the UK equity market has risen in three of the last four recessions. Often, equity market valuations, such as the price to earnings ratio (p/e), rise in periods of weaker economic growth as investors 'see through' a temporary period of weaker corporate earnings. However, that is notably not the case at the moment. The price/earnings ratio on the UK equity market is currently close to historic lows, many companies having been down valued but still exhibiting strong earnings and balance sheets.

A bear market offers opportunity

The Federal Reserve has been more aggressive in its rate cutting, aiming to shorten the duration and reduce the severity of the slowdown in the US. At the same time, the US Government has weighed in with a series of tax cuts to stimulate the economy. Even so, some would say they have been unable to prevent the inevitable. It would seem that the UK may be in a similar position.

Even if the local economy doesn't slip into recession, the mere anticipation of it can have a profound effect on markets. Many experienced investors position themselves to take advantage of the inevitable 'rebound'.

Nick Purves of Schroders highlighted this point, "It is very important to separate-out the outlook for the economy – which I agree looks poor – from that of share prices: these are very different things. A huge amount of bad news has already been priced into current share prices in anticipation of an economic slowdown." The last recession in the UK was back in 1991-92 and in the early months the UK stock market did indeed decline, but whilst the economy continued to contract for almost two years the equity market rallied strongly.

Many fund managers believe that there is a time lag between markets discounting future downturns before finally bottoming-out and then, as investors realise events are not as bad as expected, embarking on a new bull market. But this is a window of opportunity for fund managers to buy stocks they like at low prices and then wait for the coming rally.

"You make your best investments when things appear to be at their darkest hour", was a comment made by George Luckraft of AXA Framlington, summing up the need to remain focused on the long-term.

During very difficult market times many investment companies look to issue statements of support to investors. The value of these statements is undoubted as it adds comfort via reminders about past events.

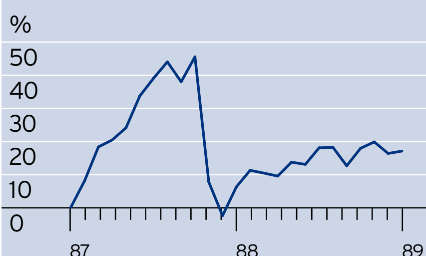
We use Invesco Perpetual for a large part of investment planning. Above we have shown you the thoughts of Neil Woodford who manages the Income and Higher Income Funds. I am including within this report, the latest 'Keep the Faith' document issued by Invesco Perpetual – it reiterates what we are saying – refer especially to the charts 'A, B & C' that look at 'Black Monday' in October 1987.

Invesco Perpetual

How to survive stockmarket ups and downs

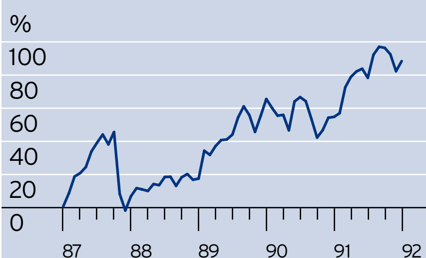
Even experienced professionals are sometimes unnerved by market behaviour. It can be easy to become fixated on the short term ups and downs of the stockmarket. So how does an investor cope with this? One way is to focus on the bigger picture – the long term.

Chart A 'Black Monday 1987' crash and its effects after 2 year period



The above chart reflects the FTSE 100.
Past performance is on a mid-price, sterling basis inclusive of net reinvested income to 31 December 1988. (Source: Lipper, a REUTERS Company).

Chart B 'Black Monday 1987' crash and its effects after a 5 year period



The above chart reflects the FTSE 100.
Past performance is on a mid-price, sterling basis inclusive of net reinvested income to 31 December 1991. (Source: Lipper, a REUTERS Company).

Chart C 'Black Monday 1987' crash and its effects after a 19 year period

The above chart reflects the FTSE 100.
Past performance is on a mid-price, sterling basis inclusive of net reinvested income to 31 December 2006. (Source: Lipper, a REUTERS Company).

Black Monday 1987 – the stockmarket's darkest day or a good investment opportunity?

Stockmarket falls can be steep, quick and all too memorable when they happen. Many people remember the market crash in October 1987 that was named 'Black Monday'. A stockmarket slump can be a worrying time for any investor and on a day as dark as 'Black Monday' it is hard not to focus on share prices as they fall. However history has shown that those who can resist the natural temptation to reduce their holdings, or perhaps are even brave enough to view such periods as good investment opportunities, may well be rewarded in the long run.

At the time, this stockmarket correction seemed disastrous as millions of pounds were wiped off the value of equities on the main UK stockmarket index – the FTSE 100. But what if we take a step back and look at 'Black Monday 1987' as part of a bigger picture?

Chart A shows the UK equity market over a two year period including the 'Black Monday 1987' crash.

Chart B shows the same stockmarket over a five year period, where despite the drop in 1987, the market not only recovered, but went on to make significant gains. Typically, when political, military or economic news is driving prices lower, the market tends to take a pessimistic view of events, prompting an initial sharp decline. However, soon after the sellers leave the market and the bottom is reached, we often see the first good news arrive, which may feed through into a market rally.

As an investor, it is important not to miss out on such rallies, as equities can deliver significant gains in the first months or years after major indices, such as the FTSE 100, hit their low points.

Finally in **Chart C**, which covers the period from 1987 to December 2006, the 'Black Monday' crash appears insignificant and the subsequent recovery of the stockmarket substantial. There have been further stockmarket corrections, between 2000-2003 for example, but again we see a recovery in the following years. The key message here is that despite some monumental events and serious setbacks over the period, the historical case for investing in equities for long-term growth remains strong.

Past performance is not a guide to future returns.

What can we learn from the 'Black Monday 1987' example?

Stay invested

It can be a natural reaction to become pre-occupied with day-to-day market fluctuations when things have taken a turn for the worse, however this could lead to some rash decisions over the future of your investments.

If you react to a market drop by selling off your investments, you are in effect locking in those losses. Patient investors have historically been rewarded by long-term stockmarket returns despite occasional market volatility.

Keep focused on the bigger picture

It's important to give your investment objectives some perspective – for example are you retiring soon or in 20 years? It's important that you review your financial goals, as they will evolve and change as you move through life.

Maintain the right balance for you

Diversifying your investments across equities, bonds and cash, as well as across a number of world markets, can help lower your overall level of investment risk and make for a smoother investment ride.

How to survive stockmarket ups and downs

Time in the market, not timing the market

So, we have seen that stockmarket falls can be sudden, but very often markets can rise just as rapidly. With this in mind, you might think that the best course of action would be to try and anticipate the market's direction and move your investments accordingly. However, it is very difficult to try and predict stockmarket movements and trying to 'time' your investments over the short term, as the stockmarket rises and falls in unanticipated spurts, makes it easy to 'mis-time' and lose out on the gains. Market rises and falls should be viewed as part of normal stockmarket life.

Fortune favours the brave

If you are investing for the long term, the consensus is that better returns can be made by holding on to that investment for 5 to 10 years plus, rather than investing and trying to second guess the stockmarket. While there are no guarantees, history has shown that those willing to invest in equities over the long term have often enjoyed a higher return on investments.

Get good advice

However, if you do decide that the markets you're invested in fluctuate too much for your comfort, you may wish to speak to your financial adviser about developing a more suitable balance of investments to match your own attitude to risk.

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Important information

The value of investments and any income from them will fluctuate (this may partly be the result of exchange rate fluctuations) and investors may not get back the full amount invested. Past performance is not a guide to future returns. Where Invesco Perpetual has expressed view and opinions, these may change. Further information on our products is available using the contact details shown. Telephone calls may be recorded.

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What for the future?

The FTSE chart earlier in this report looked at Bear Markets and their timescales. It is felt that we are in a mature phase of this market.

What catalysts may see the recovery starting?

Oil prices falling has been a start – the price has retreated from $147 a barrel to $122 a barrel in very recent weeks. This is good for global economic planning as it undoes some of the 'heat' that oil price inflation adds to an economy. Most major economies want to manage inflation and keep it low. This is obviously very difficult when oil, a component/function of nearly all things in all markets, is rising. Its fall in price has enabled economists now to consider further UK interest rate cuts as probable towards the end of this year.

What this does for all of us?

Industry looks to its funding from Banks – these are tied up at present as the cost and risk of 'debt swapping' is still uncertain between institutions who lend to the broader market. If interest rate falls occur, then risk becomes lower in 'debt swap markets' and so more liquidity i.e. more funds enter the financial markets and also funds move around with far greater ease. This would then inevitably lead to the unwinding of the 'Credit Crunch'. Couple this possibility with the Government considering underwriting risk for institutional investors who trade in mortgage debt, and there is now some hope for this market to unwind during this year.

Normal banking practices resumed coupled with inflationary pressure relieved in no small part by a more sensible oil price, and things start to turn.

To try to be precise about timescale would be brave and nearly foolish! However, Summer is always an unpredictable period in markets and so we expect to see some stability resume in September.

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