



## CARTLIDGE MORLAND

### INVESTMENT UPDATE

15 July 2008

**We anticipated volatile financial markets until Q4 2008 as a consequence of the 'credit crunch' that became fully apparent in August last year.** The term 'volatile' suggests sharp movements both up and down. More recently, investors have witnessed a sustained sell-off, with the FTSE 100 Index down from the 6000 level, (at which support seemed to be maintained), to 5170 this afternoon. This is a matter of considerable concern, as presently there is little to suggest a short-term sharp recovery and asset prices may yet fall further.

Over the last six months equity markets have corrected considerably as a result of the ongoing credit crunch, slowing economic growth and rising inflation, fuelled by record prices for oil and foodstuffs. Consumer confidence in the major world markets has fallen rapidly. What markets most dislike is uncertainty, and currently, uncertainty is prevalent.

It is worthwhile noting that all major equity markets/regions/asset classes are similarly affected. Since 2 January 2008, the negative 'total return' (ie inclusive of dividend yields) from the major markets over the period to 11 July 2008 is shown in the following table:

#### **Total Returns from World Markets/Asset Classes 2 January to 11 July 2008**

<b>UK</b> (FTSE 100)	-16.05%
<b>US</b> (S&P 500)	-13.79%
<b>Europe</b> (FTSE Europe ex UK)	-16.91%
<b>Asia Pacific</b> (FTSE Asia Pacific ex Japan)	-14.90%
<b>Japan</b> (Nikkei 225)	-12.24%
<b>Emerging Markets</b> (IMA Global Emerging Markets)	-15.25%
<b>UK Corporate Bonds</b> (IMA UK Corporate Bond)	-4.60%
<b>UK Direct Property</b> (ABI UK – UK Direct Property Pensions)	-4.96%
<b>UK Property Securities</b> (ABI UK – UK Property Securities Pensions)	-16.49%

Source: Lipper Hindsight

In a balanced portfolio regional diversification combined with asset allocation to less volatile asset classes (such as bonds and property) will usually reduce overall risk. The losses we are witnessing within our portfolios are considerably less than those suggested by movements in the FTSE 100 and FTSE All Share indices. However, bond markets have also experienced a torrid time and apart from a brief improvement in the gilts market, bond returns have also been negative. Yields in the investment grade bond markets are currently very attractive, but this is partially a consequence of the perceived risk of higher inflation and interest rates. Conditions in the commercial property market are expected to remain challenging well into 2009, although the heavy losses sustained in 2007 are unlikely to be repeated.

Cash remains an attractive hold, whilst deposit interest rates remain relatively high and the wholesale money market offers even better returns. Until inflation is firmly under control, the Bank of England is unlikely to cut interest rates. We believe further rate rises to be unlikely, provided wage rises remain subdued. The Governor of the Bank of England predicted the sharp rise in

inflation we are now experiencing, but has also indicated that he believes it will be of short duration. The Bank's forecasting has been fairly accurate.

## Acceptance of Risk

In the present climate, all investors should re-examine their tolerance of investment risk. We shall be placing great emphasis on this in our review meetings. Positively, the cash weightings in our portfolios are much higher than usual, as we reduced the weighting in bonds in favour of cash more than 12 months ago. Cash, combined with fixed interest holdings, can be used to meet income needs as an alternative to selling equities. There are few (if any) Cartlidge Morland clients, who will need to sell equities to meet income needs, for some considerable time.

Conversely, many will wonder whether they should be holding any financial assets other

than cash deposits presently. After all, cash deposits are largely immune from losses, whilst offering a reasonable interest rate. Index-linked gilts/national savings certificates and wholesale money market funds can still present greater opportunities.

To meet this need, we do provide a 'Very Cautious Portfolio', intended to provide a better return than a reasonable cash deposit account, at very modest risk. Many of the funds/instruments contained within this portfolio are routinely included in our balanced portfolios too. If you would like to use our 'Very Cautious Portfolio', please contact your Cartlidge Morland consultant.

## Should investors continue to remain invested in equity/bond markets, with so much obvious uncertainty?

Stock market investments should be held for the longer term, as over time equities out-perform cash. Although deposit rates are relatively high it is questionable how much the 'real' return is, with the official UK inflation rate at 3.8% and 'real' inflation apparently much higher. However, as evidenced by events this year, stock market corrections can be very sharp, which leads investors to question the merits of holding stock market investments. There is a perception that either the lay investor (or a professional adviser) can judge market timing with a reasonable degree of accuracy. Numerous studies have proven this perception to be erroneous – although anybody making such judgements will

sometimes be right. More often however, they will be wrong.

Market timing is notoriously difficult to get right. Equity markets can fall dramatically over short periods of time but equally, can recover quickly too. There is a risk that investors may crystallise losses by selling during a fall, only to miss regaining them when sentiment improves. There is a real danger of missing the best gains when not invested in the market.

Fidelity Investments has analysed the returns from the UK and US stock markets over the period 1993-2008 and their findings show the impact on performance of missing the best stock market days.

### Average annualised stock market returns (%) over 15 years illustrating the effect of missing best days

Market	Index	Stayed Fully Invested	Best 10 Days Missed	Best 20 Days Missed	Best 30 Days Missed	Best 40 Days Missed
UK	FTSE All Share (£)	8.89	5.9	3.62	1.64	-0.17
US	S&P 500 (US\$)	9.88	6.45	3.8	1.47	-0.55

Source Fidelity Investments. All figures show annualised, total return, taken from 15 year periods, starting each consecutive month from 31/05/93 to 30/05/08 in local currency terms. Basis: Bid/Bid, net income reinvested, no initial fees.

This analysis shows that if the best 10 days are missed in the UK and US markets then annualised returns reduce by nearly a third. If the best 40 days are missed the impact is even more dramatic. This illustrates why market timing is a high-risk strategy. Obviously if one could miss the worst days, then returns would be higher, but predicting the bad and good days is difficult and more a question of luck. It is the length of time investments are held, not when they are made, that it is key to benefiting from equity returns.

Another consideration in deciding whether to invest (or sell) is whether share prices are at such low levels that the market offers good value. Value driven strategies are considerably more reliable than those purporting to rely on 'timing'. There are

sectors in the UK market that have fallen dramatically in the last twelve months – including banks, property and general retailers. The table below shows the performance of these sectors in comparison to two sectors that have had positive returns – oil & gas and mining. The FTSE 100 has held up well due to the energy and mining sectors, as they comprise such large proportions of the index.

Where falls have been so dramatic, exceptional investment opportunities are likely to exist. Cartlidge Morland's strategy is to gain or retain exposure to such opportunities through well-diversified, active funds, run by managers who have the experience and conviction to invest wisely, when other investors are selling equities.

Index/Sector	%
FTSE 100 TR	-11.58
FTSE All Share/Banks	-37.99
FTSE All Share/General Retailers	-43.95
FTSE All Share/Mining	36.21
FTSE All Share/Oil & Gas	11.49
FTSE All Share/Real Estate	-39.93

Source: Lipper Hindsight.  
Percentage growth 29/06/07 to 30/06/08. Total return

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## Value

Many major stocks are trading at exceptionally high yields. This is an indicator of value, but in some instances this 'value' results mainly from anticipated reductions in the dividend yield, or the danger of further 'write-offs' in the case of the banks. It may not therefore be 'value' at all.

Interest rates and wholesale money markets will not remain at current levels over the medium term. Stability in these markets will return, partially of necessity fostered by the support of the central banks and also because confidence will gradually be restored, as the underlying strength (or otherwise) of each bank's balance sheet becomes apparent.

Ultimately, investment follows business/capital growth opportunities (eg the current energy boom) or income yield. If money markets offer an attractive real yield, with little risk to capital, whilst equities offer an uncertain yield, with perceived high risk to capital, then equity prices will fall. We have now reached the point at which equity market yields are attractive but the extent to which earnings may yet be under pressure is still unclear in many sectors. Efficient markets supposedly anticipate economic cycles. So it might be argued that the risks to earnings presented by the economic slowdown (and inflation) are now priced in. Whether this is the case or not, confidence will remain very fragile until markets have reassessed the prospects for individual companies, including recovery potential. This reassessment will take place against an increasingly gloomy economic background both globally and for the UK.

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## Strategy

We have consolidated gains over the past couple of years and despite recent falls, most portfolios continue to show healthy gains. We shall continue to consider further consolidation but in a manner that allows continued upside when markets recover, whilst protecting further downside risk. We shall be maintaining our weightings in UK 'equity income' funds, which provide high yields and considerable potential upside. Overseas, we increasingly believe the US presents better medium term prospects than Europe and that longer term, Asia Pacific and emerging markets present great opportunity. Shorter term, those markets may prove expensive and we have been taking gains. UK investment grade corporate bonds offer very attractive yields and high credit quality. There is continued risk to capital, if perception as to the prospects for interest rates and inflation continues to worsen. We are matching fixed interest exposure with cash and near cash exposure via deposits, wholesale money market funds and National Savings. Earlier in the year we were reasonably certain that investment grade bonds would produce a better 12-month return than cash. Although we still consider there to be reasonable prospect of this there

is less certainty, hence our decision to continue holding more cash than usual.

For clients who are already invested, we see little reason yet to expand risk. Indeed we wish to reduce it where we can, but not at the expense of recovery prospects. For those sitting mainly in cash, there is likely to be considerable opportunity at present market levels – although short-term losses will be a considerable risk for anybody investing now. We therefore recommend partial 'balanced' investment immediately, complemented by equal exposure to our 'Very Cautious Portfolio'.

We have not issued a dramatic 'sell, sell, sell' recommendation, but we have reduced risk on a gradual basis over the past two years. This has been insufficient for most to avoid losses over the past 12 months but these have been significantly mitigated.

Defensive action will continue to be taken but not at the expense of recovery prospects. Ultimately, each individual needs to be comfortable that he/she can readily meet personal needs whilst awaiting recovery.

**Any concerns with regard to the level of risk within your portfolio should be discussed with your Cartlidge Morland consultant immediately.**

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