

Big reductions at the January investment market 'Sales'

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Despite the events of the past few years, and contrary to what most of the financial services industry suggests, investing is actually a relatively simple process. The reason that many investors are taken in by the propaganda is that they confuse speculating with investing.

While much has been said about 2008 marking the end of capitalism, we believe the extreme market events that have occurred over the past eighteen months demonstrate that capitalism and capital markets do work. The bad investment decisions made by banks, other financial institutions and consumers have eventually been shown up by the market, as evidenced by the collapse of the share price of most of these organisations and the rapid reduction in the values of most assets, most notably property.

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Capitalism's lifeboat

Capitalism, with all its flaws, is a bit like a lifeboat. In the eye of a storm and very rough seas, it may well capsize, but eventually it will right itself. The crazy bubble in asset prices which occurred over the last ten years or so, fuelled by cheap, easy money and financial products that were too clever by half, are gradually being purged from the world financial system. The journey will be long and not without drama, with the financial services sector shrinking in size as a proportion of world economic output, to reflect its true value.

At its simplest, investment boils down to key choices: one can either invest equity in businesses, in return for the potential to share profits arising from their business activities, or one can invest in bonds to lend to companies and governments in return for interest. Every other investment opportunity is a derivative of these two key choices. Over the very long term, investment in equities has to produce a higher return than investment in bonds to compensate the investor for the substantial extra risk that he takes.

Two types of investor

There are two types of investor: those who believe that investment returns revert to their long-term mean (average) and those who don't. At Bloomsbury, we are in the former group, as is Jack Bogle, the founder of Vanguard group, the largest provider of index funds in the world.

The long run mean return from equities has been about 10.10% per annum and this compares with dividend yield and earnings growth of about 9.90% per annum. In the short term, stock markets rise and fall based primarily on investors' confidence. When confidence is high, markets rise, because investors are prepared to pay a higher multiple for current and future price / earnings (known as the PE ratio). At the market peak in October 2007, investors in the UK All-share index (excluding investment companies) were prepared to pay a multiple of 12.87 for those earnings and an immediate dividend yield of 2.81%. Just over fifteen months later those same investors are prepared to pay a multiple of 8.44 for those same earnings and an immediate dividend yield of 4.92%.

PE ratios will fluctuate up and down like a boat in the ocean. Sometimes the waters are calm and sometimes they are choppy. The key is to focus on the investment horizon and hold the course steady. Trying to second guess the direction of the market's confidence level in the



short term is a fool's errand. Confidence is driven mainly by news, which itself is random, and therefore unpredictable. Investing, on the other hand, is participating in capitalism which provides attractive long term mean returns. Long-term use, in this context, is a period of 25 years or more, not one, five or even ten years, as economic 'mayhem' takes time to sort itself out.

Clearly, there are times when stock market values deviate above the long-term mean and others, like now, when they fall below. If you have a 25 year time horizon, as most families do, then these variations are unlikely to impact greatly on your long-term returns. Speculation has, historically, only added 0.10% per annum therefore short-term speculation adds very little to the long-term results. However, emotion plays a big part in investment decision. If you are intending to commit cash to an investment portfolio but are nervous about incurring short-term losses, just check whether markets are priced at or below the long-term mean return.

Currently, the FT SE all share index is trading at 2040 (20 January 2009). Based on current earnings this is a multiple of 8.44, compared with the long run average of 13. The dividend yield is 4.93%, compared with the long run average of about 3%. No one can predict what will happen in the short term, the numbers are telling us that if we wish to participate in capitalism, over 25 years or more, today represents the opportunity to buy into that participation at a price which is below the long-term average. So while any cash invested in the stock market could still fall in value in the short term, if you believe in reversion to the mean, as we do, then there is no logical reason (although there may be a number of emotional ones) to defer making long-term investment decisions. It is unlikely that you will be paying over the odds for current and future corporate profits, even if they fall significantly from current levels.

....emotion plays a big part in investment decisions

Bloomsbury's principals have each been in the financial services sector for over 20 years and we have no idea which way the market is heading in the short term. What we do know is that in the context of the mean return from dividends and earnings growth arising from world stock markets, currently there seem to be an attractive 'sale' on, where it is possible to pick up financial assets at much reduced prices. If your time horizon is long-term, and most of us have much longer term horizons than we realise, then don't put off reviewing and implementing a proper investment solution. Rather like starting a family, there's never a 'right time' to start.

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