

Reviewing your investment strategy - non client version*

Are markets efficient?

We work on the basis that markets are efficient, in the sense that you are not going to discover any secret information that will give you an edge over other investors. This is the basis of the Efficient Markets Hypothesis; supported by many academics.

A key observation of the hypothesis, that it is difficult to beat the markets consistently over time, has stood up well to the shocks we have seen.

The Financial Times (FT) has just completed a comprehensive series of articles on the future of investing. It is reassuring to know that if more investors had followed our lead they would have healthier finances today. The FT found that many of the important assumptions, on which many other professionals base their careers, have been proven to be wrong. Their alternative ideas of market timing, forecasting and star fund managers are often a waste of time and costly.



● Vanguard has launched funds in the UK

The FT has suggested that we are going to change the way we judge fund managers. Many so-called clever fund managers have not delivered out-performance or much in the way of diversification. Many of them used what we would call 'hedge fund' strategies; using low interest rates to borrow money to buy assets that were expected to increase in value. It is the type of strategy that can be made to sound very clever at the time, until one's luck runs out. You could make similar bets yourself by borrowing money on your home and making a punt on the stock market or commodities. You look clever when your bet pays off and extremely foolish if you invest just as markets are turning down.

Unfortunately, the investors who do feel shaken up because their adviser let them down, can miss future opportunities because they are less likely to continue investing.

“To be generically against the markets would be almost as odd as being generically against conversations between people.” The recent crisis was not a generic failure of markets but a specific failure of finance”

-Amartya Sen, Economist and Nobel Prize winner



Still waters run deep

Also, we lose their valuable contribution to the economy, which is channelling their savings capital to productive business activities that the economy needs in order to grow.

What will the future look like?

Future stock market conditions could be likened to the public attending a regular car boot sale in their locality. This time it is taking place in a muddy field after weeks of rain, and to encourage potential customers to don their wellingtons, the traders have to make them more enthusiastic by advertising keener prices.

In a similar way, stock market prices must be more attractive when there is a thought of difficult economic conditions ahead.

The world in the future is going to have some differences compared to the past, and one difference is that the rate of growth is going to be slower.

The economic playing field is now covered in muddy patches and these are going to slow the pace down.

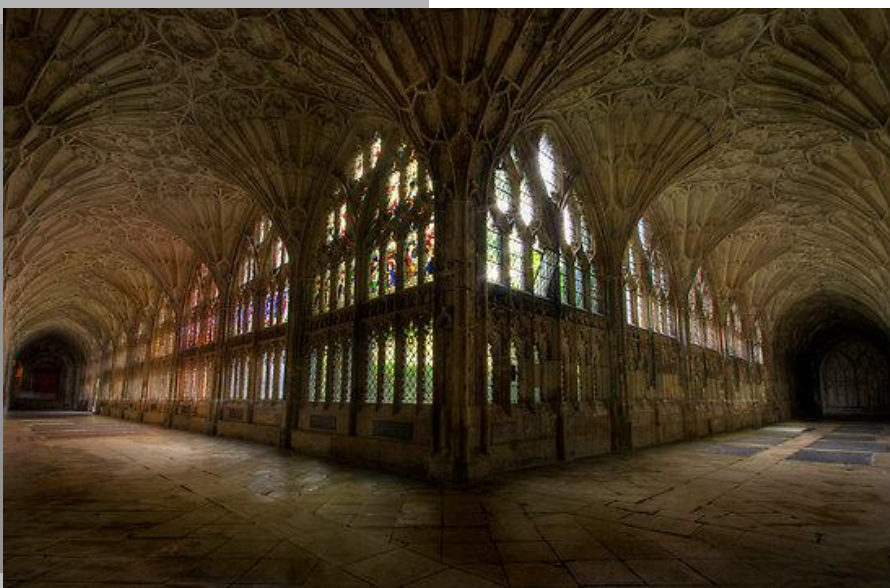
It is reasonable to anticipate a slowdown assisted by continued high unemployment, a world banking sector with difficulties, reduced demand for goods and heavy debt on the balance sheets of households and governments (especially in Britain and America) which will curtail spending.

Household debt started to increase in the 1980s and it has been building up for 25 years. The spending power released from household property, assisted by slack lending, is going to take some time to unwind. Meanwhile, the householders who are building up their savings and reducing their debts are no longer buying goods and services at the same rate.

With governments and companies tightening their belts we become less efficient. For example, the computer at work is not replaced, you travel in an ageing train, and the creaking van that delivers a firm's products is less productive than the latest version.

In other circumstances they would have been replaced. Over the whole economy, productivity suffers and so does the growth of wealth.

Time for a change of direction



The tight lending policies of banks will mean the loss of potentially good small businesses, which are the wealth generators and large companies of the future.

For the next few years this reduction in spending, lack of enthusiasm for reinvestment and rationing of bank finance will have a stagnating effect on living standards for many years to come.

Our Government must resolve the high level of debt

Sweden suffered from a bust banking system in the early 1990s and the way out was to take a slice off all areas of government spending and raising taxes.

Before interest payments, Britain's budget deficit is currently -10% of GDP and this must reverse to a surplus of +3.4% in the next five years to put us on an even keel. So belts are going to be tightened.

The markets

The FTSE100 has just had its best ever quarter and it is up 20%, the American market has made a similar recovery and emerging markets have made major gains (the Brazilian stock market is up 60% so far this year).

Are these recoveries based on merit or because markets have been lulled into complacency due to the huge government stimulus in the UK and globally - 'quantitative easing'?

All the information mentioned here is not new. Many others have made similar observations and the consensus view is reflected in stock market prices and bond yields already. However, the markets are not efficient when we consider human behaviour, and the efficient market hypothesis does not work in this context. If the markets were perfectly rational there would be no stock market crashes!

Interest rates

Interest rates are at a record low and yet the Government is heavily in debt with very little attempt to control it just now. However, the Government is allowed to get away with paying very low interest rates on its gilts. In the future interest rates will go up and so will the cost of Government debt.

This is one reason why our defensive funds are 'very defensive' - only short-dated and high grade bonds and short-dated gilts.

“Only a few countries have successfully repaired themselves when carrying so much debt”



Have you seen my blog? Click on the box below to read my views and ideas. and perhaps leave your comments?



Changing your portfolio strategy

As forecasting does not work we do not employ it as a tool when designing our portfolios or giving advice. However, this does not prevent us from using common sense and doing a few sums.

If the world is going to slow down, it may be prudent to review your asset allocation.

The introduction of Vanguard's funds

Vanguard's entry to UK market is welcome, as it is the largest provider of index funds in the US, where it introduced the first mutual index fund in 1976.

Vanguard starts with a range of equity index and fixed income index funds with very competitive pricing.

It is interesting that Vanguard is presently only available to fee based financial advisers, and the group does not pay any commission. To quote Vanguard "...that means bringing the Vanguard mission to be the highest value provider of investment products and services to UK investors...Our initial offering consists of a range of index tracking mutual funds and is distributed primarily through platforms used by fee based advisers. This means we work with the increasing number of IFAs who are moving away from a commission based model to what is known in regulatory terms as a fee based model."

The world is beginning to recognise, all be it slowly, that commission based advice is biased. Vanguard has set out its position that it does not agree with commission based advice.

Since Vanguard opened in the UK there have been reports in the press that this has had an immediate impact forcing other index providers to cut their costs.



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