

A VIEW FROM THE BRIDGE

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Welcome to the third edition of “A View From The Bridge”. I hope I won’t have to eat my hat (it is not yet 10 September) but it is not looking like a year when it paid to “Sell in May and go away and buy again on St Leger’s Day”. It may be unfair to suggest that this adage represents a “consensus view” but is certainly often quoted and could be viewed that way. In our first article we discuss the importance of knowing what the “consensus view” is and we introduce our “themeometer” – a way of measuring the extent to which we deviate from consensus.

Last edition we considered the power of crowd psychology; in this edition we consider another aspect of human behaviour – whether, instinctively, we are risk seekers or risk avoiders. This leads us neatly to our third article which discusses actual investor behaviour, thoughts and possible future intentions in relation to the UK market.

Finally, I make no apology for drawing your attention to “A Day” 6 April 2006, a “once in a generation” event. The regime for all types of pensions is changing and with only a very few exceptions (e.g. individuals already drawing their benefits from an occupational scheme and with no prospect of drawing other pension benefits) everyone should review their pension situation. The changes, which include increased flexibility and changes to draw down rules, are significant. Speak to your pension adviser, now, before they become like plumbers – expensively scarce. If you have lost touch with your adviser or never had one, we would be delighted to make recommendations.

Philip Todd
Managing Director

Consensus Views and Portfolio Performance

‘To me, consensus seems to be the process of abandoning all beliefs, principles, values and policies. So it is something in which no one believes and to which no one objects.’

Margaret Thatcher

Our former Prime Minister possesses distinctive and clear-cut views on the value of consensus thinking. For investment managers, on the other hand, knowing what the consensus is on the economic situation, the prospects for inflation, interest-rate movements, dividend growth and so on – is of great importance.

In any market where capital can move freely and where there is a consistent and regular flow of information, buyers and sellers interact to set a price of any particular asset. In developed markets, the efficiency of information distribution and the large number of active participants on a daily basis tends to mean that markets are relatively ‘efficient’, reflecting at any one time all relevant information that is in the

public domain concerning any tradable asset. And the larger the asset or asset class, the more active participants there are likely to be, and thus the more efficient the market. Far more investors and analysts track the fluctuations of stocks such as BP or HSBC than of a small AIM-listed security, and such securities may take somewhat longer to react to fresh news than larger, more liquid stocks.

Of course, having assessed what the consensus view of any particular asset is, the investment manager must then decide whether that view is correct, and if not, how to profit from the misperception. In previous publications, we have noted how markets can occasionally be driven by irrational and unsustainable beliefs. So-called ‘bubbles’ can and do develop and it is at such times that a policy of taking a contrary view is of vital importance for preserving capital in the long term.

Such a stance can be uncomfortable, but what is clear in the investment world is that superior performance never results from following the crowd. Diverging at times from the consensus is the only way to generate

above-average returns and at Taylor Young we seek to do this through the identification of themes in markets – ideas to which we believe opinion will gravitate in the future, or which will become dominant over time. **We are therefore introducing a ‘themeometer’ to evaluate the strength of our themes and monitor how they compare vis-à-vis perceived market opinion.** At the moment, the questions we are considering include:

- Will the price of oil reach \$100 per barrel next year?
- How strong is the housing market in the UK and USA?
- Will the current trend of outsourcing to India and Pakistan continue?
- Is the Chinese economy due for a hard landing?
- Will the demand for luxury goods be as strong if consumers retrench?

These are just five examples of many themes that we are seeking to evaluate. There are myriad views in the market on all these subjects but on most it is possible to identify a consensus view – or an ‘on balance probably’, or ‘probably not’. For example, if we take the first question, the consensus is that oil will not reach \$100. Yet there is a range of conceivable, if unlikely, circumstances in which it could, in which case there would be a profound impact on the world economy. We are currently in agreement with the consensus on this issue, believing that there is only a very small chance of such an extreme move in price. On the other hand, it is the majority opinion that there will be a sharp retrenchment in China’s economic growth; we are currently much more positive than the consensus here.

Our themeometer will represent the degree of our enthusiasm for various themes or opinions – and hence our divergence from consensus – by colour coding: a ‘blue’ theme would be one to which we do not subscribe, and where our exposure to the market is limited or zero. A ‘red’ theme is one that we favour and where we seek to gain exposure through investing heavily in a stock or range of stocks, both domestically and internationally. For certain themes, the range of opportunities in the UK market may not be extensive, but global equity markets might offer broader possibilities. Healthcare and telecommunications are key sectors where the range of international companies complements investments within the UK equity arena.

All investment managers and advisors should constantly challenge conventional wisdom or received views, particularly when such views emanate from quarters that have few or no responsibilities for the stewardship and management of client funds. Thus, we will reassess our themeometer on a regular basis and respond accordingly.

So consensus, or the lack of it, is very important from our perspective. Naturally, we are not arrogant enough to conclude that a consensus view is always an incorrect one; all we seek to ascertain are the reasons for it, and, even if it may be broadly correct, how and why it may change in the future.

To conclude, a view from an eminent philosopher who saw many consensus views come and go over his long life:

‘The fact that an opinion has been widely held is no evidence that it is not utterly absurd; indeed ... a widespread belief is more likely to be foolish than sensible.’

Bertrand Russell

Risk, Loss Aversion and the Market

Why should I bother to pay the insurance premium to cover the possible loss of my property through fire or other disaster? The main reason is that most people cannot afford to run the relatively tiny risk of total loss of their property, and are prepared to accept an almost certain loss (that of the insurance premium) to guard against this eventuality.

However, the more confident we are that we have insured against any specific risk the more complacent we tend to become about the specific nature of the risk itself. For instance, in the United States during the 1980s the savings and loans associations, which provided funding for homeowners and borrowers, enjoyed deposit insurance guaranteed by the Federal Reserve. Collectively, with one or two notable exceptions, the associations embarked on a series of high-risk investment strategies, safe in the knowledge that if things went wrong the taxpayer would foot the bill. The bail-out that followed was the largest in American financial history. (The American writer P. J. O’Rourke makes a similar point when he considers the best vehicle in which to make 60-mph handbrake turns. Is it your right-hand-drive car or your left-

hand-drive car? Of course it is neither – it is a rented car.)

These are examples of a phenomenon known as ‘moral hazard’. It can be encountered in all parts of our daily lives, but has interesting applications when considering how and why investment decisions are made. Clearly, any investor would relish the opportunity of investing in a ‘sure thing’, if such a thing ever existed, but in a more realistic world, are investors in general risk-seekers or risk-avoiders?

The answer is, interestingly, rather complex and depends to a large extent on the context in which the investment decision or risk is set.

Consider this proposition: you are offered a certain gain of £10,000, or a 50-50 chance of gaining £20,000 or of gaining nothing. Statistically, the ‘pay-off’ value of both options is the same but, given the choice, the large majority of people opt for the first – they are, therefore, risk-averse. However, when presented with a proposition of a certain loss of £10,000 or a 50-50 chance of losing £20,000 or of losing nothing, the majority go for the 50-50 bet. Thus, when a choice involves losses, we tend to turn from being risk-averse to risk-seeking.

Daniel Kahneman and Amos Tversky¹ have written extensively on the issues that flow from experiments such as these, and have developed a branch of economic science known as ‘Prospect Theory’. Their findings have significant implications for the management of portfolios. A favourite market aphorism is to ‘avoid catching a falling knife’, or not to assume that just because a stock is falling in price it becomes de facto better value. It is often the case that the price of a stock is falling because the fundamentals of the company, or the industry in which it operates, have changed. It is thus a risk-seeking strategy to establish a lower average price for such a stock; all one may be doing is heightening risk and increasing an ultimately losing position. Of course, stock prices move for reasons that may not be stock-specific, such as a terrorist outrage, so it is important to distinguish between stock-specific and non stock-specific price movements. Nevertheless, experience and empirical studies show that ‘averaging down’ is a strategy that can often be counter-productive in the management of a portfolio of risky assets.

Similarly it is seemingly counter-intuitive to buy a stock on rising prices because at first glance it may

appear that the stock is become ‘more expensive’. Again, the price may be rising for a good reason: the company’s prospects may be improving, better management may have been brought in, or it may be better placed to win new business. In addition, buying such a stock may well be less risky than ‘averaging down’ in a falling stock, simply because the fundamentals on which the stock is being valued are more secure in the first case. Human nature, as illustrated by Kahneman and Tversky, can thus be inhibiting and misleading in the management of assets; indeed the phenomenon of taking profits in rising stocks whilst allowing losses in falling stocks to accumulate has been termed ‘pulling up the flowers and watering the weeds’.

Both moral hazard and risk tolerance and aversion are endemic in markets, so perhaps, pushing the horticultural metaphor a little further, it would be instructive to replace the traditional floral displays in the reception areas of fund-management offices with a large vase of stinging nettles!

¹Kahneman and Tversky: ‘Prospect Theory: An Analysis of Decision under Risk’, *Econometrica*, 1979

The State of the Nation.....

While the UK market has risen by over 65% since its trough in March 2003 it would seem that a significant number of private investors have been sellers of equities for most of this period. The length and depth of the 2000 - 2003 bear market caused some existing and most would-be private investors to lose confidence in an asset class that has served long-term investors well over time. Despite the UK market trading at close to three year peaks, individual investors have been taking money out of shares and equity funds and depositing cash in record amounts. In May of this year there was a net outflow of £83 million from equity funds and a net inflow to building society savings accounts of nearly £800 million, almost double the amount for the same month in 2004.

Is this the herd instinct at work, which has historically seen investors buy at the top of the market and sell at the bottom, and could it be a contrary sign that share prices are likely to gain further ground? Could it be part of the ‘Sell in May’ syndrome? Many investment managers expect private investors to be significant net buyers of shares before the market peaks. Markets have been recovering strongly for nearly two and a half years and considering the length of previous bull

markets there is some cause for a degree of caution. Nevertheless, valuations of shares remain reasonable against a backdrop of falling interest rates, a favourable market yield and attractive dividend growth.

A recent survey by Merrill Lynch showed that almost half of individual investors believed the UK market had moved sideways or down over the past two years even though it had risen by well over one third during this time. Negative sentiment towards equities is not only for the reasons mentioned earlier. Higher oil and commodity prices, a weaker property market, wary consumers and slowing economic growth reflect individuals' caution. When you add to this the possibility of further terrorists attacks, one can understand that fear is still a dominant force which keeps many potential long-term investors on the sidelines.

We believe that valuations are acceptable and that the market offers value to long-term investors who can afford to take the risks. Afford is an important word in this context. As Investment Managers we believe that participants in the market should take sensible precautions prior to investing in equity markets whatever the prevailing economic and political conditions are at the time. Investors should take a long-term view, and perhaps a five year time horizon on the segment of their assets held in equities.

It is responsible and prudent to hold up to one year's living costs in cash and index-linked gilts. The returns on cash and gilts are likely to be low but these assets are insurance against risk and should prevent you from becoming a forced seller if markets encounter difficult periods. It is, however, worth noting that the post-tax returns from cash, in particular, may be eroded by inflation and that the real value of capital may thus fall.

In a low inflation environment it also makes sense to reduce debt and borrow less. While property has been an excellent long-term investment one should remember that your house is where you live and not an investment. Just as we advocate prudent diversification among the various different asset classes (cash, bonds, equities, property, alternative investments), we would also advise that the exposure

you have to equities should be well diversified. As a firm that believes in long-term investment we know that market moves come in short sharp bursts and by not participating in them fully, returns can be reduced disproportionately.

Each quarter, GFK Martin Hamblin surveys a sample of 2000 adults to analyse their investment intentions. Their latest figures show that the tide may be turning for equities with the prospect of higher net inflows and a 40% reduction in sales. Over the last 30 years shares have risen at about three times their normal speed. This is unlikely to continue in the long term but they should rise in line with the economy at the very least and rather more with a good manager at the helm.

We all know that markets at times can appear to be irrational but as Keynes said "*markets can remain irrational longer than you can remain solvent.*"

One can wait a long time to be proved right or wrong by the market.

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