

A VIEW FROM THE BRIDGE

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Welcome to the fourth edition of "A View From The Bridge". We are delighted with the feedback that this new initiative has provoked and trust that any reader unconvinced by any article will feel free to challenge us.

It is looking likely that 2005 will be a very positive year for most equity markets which is in contrast to the bond markets, particularly in the UK. One of the most interesting markets this year has been Japan and we have been careful not to fall into the trap discussed in our first article, where we turn again to the subject of behavioural finance. Having had virtually no exposure in Japan for some time, it would have been easy to continue ignoring it.

Elsewhere, the Editor reveals his age and argues that in the real world, inflation is more of an issue than Government figures would suggest. Finally it would be remiss of us not to focus again on pensions. Please review your own situation now (and that includes any private-client solicitors, accountants and investment managers reading, who may be excellent at looking after their clients but often forget to put their own house in order). Forgive me for being repetitive but if you have lost touch with your pension adviser, or never had one, we would be delighted to make recommendations.

*Philip Todd
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Out Of Sight, Out Of Mind?

There is a perhaps apocryphal story of a Tokyo-based translation service which, when asked to put the well known English idiom of the title above into Japanese characters came up with a version which read 'invisible maniac'. However, there is a serious point here which has some relevance to our job at Taylor Young as investment managers. We have alluded before in these columns to the innate and emotional influences that can affect decision making in all walks of life, and not least in financial markets. I was particularly pleased, therefore, to see recently a most interesting piece of empirical research from a well regarded performance measurement company, which examines in detail the concept to which the title of this piece refers.*

Essentially, there appears to be good evidence to suggest that investment managers have demonstrable skill in picking stocks. As a group, they are clearly shown to be able to identify and invest heavily in stocks which, through whatever investment process or stock screen they use, have the capacity to do better in price terms than a general stock market index. However, and this is where the title is of relevance, this study also shows that stocks which tend to be overlooked or not heavily owned by conventional fund managers, often **perform even better than their selections**. This rather melancholy fact partially

explains why most fund managers struggle to beat general stock market indices and is known as 'the endowment effect'.

The endowment effect is a concept in the field of what is known as 'behavioural finance', which examines how human nature affects the decisions and choices that people make. It is a characteristic of most people that they tend to value objects more because they own them. This trait of character has been widely observed in areas of human activity but its relevance to financial markets is that investment managers have clear choices to make in the construction of portfolios. Active managers do not hold all the stocks in the market and have to make decisions about which stocks to hold and which not to. Those that are owned are subject to significantly closer analysis in terms of price movement, comments from directors and analytical input from stockbrokers than those which are not owned. Indeed, there is sometimes some entirely understandable systematic bias in interpreting data concerning stocks that are held in a more favourable light than is justified whilst placing a more negative slant on facts concerning stocks that are not held. This 'confirmation bias' is another observable trait of human nature; admitting that we are wrong about something is often embarrassing and occasionally extremely painful. What is often the case is that we do nothing and wait for events to turn

in our favour, which is, to be fair, what sometimes happens. It is these situations that we remember with more clarity.

Markets, however, are more precise than memory and the aggregation of price data and its interpretation is not easily subjectively manipulated. Our task as investment managers is thus dispassionately to monitor both stocks we currently hold and stocks that we do not, but which we might in the future. The development of our 'themeometer', where we monitor in diagrammatic form asset classes and geographical areas of world markets, is an important new tool in our investment armoury. We are certainly realistic enough to know that we will not be able to cover and research all the byways of all investment markets globally but at least we can aspire to pick up trends and patterns in areas of markets where we are currently unrepresented and change our portfolios in order to make sound investment decisions on our clients' behalf.

Another feature of markets is a tendency to 'rotate', or for investors to favour one area of the market over another at any one time. These changes in sentiment often occur due to understandable moves in political circles or for economic reasons such as changes in tax structures. Sometimes, though, as we have mentioned before, investment 'bubbles' or irrational exuberance takes hold of markets and they move far more than is retrospectively justified by events. Here again behavioural factors can be seen at work, often in a somewhat sinister fashion. The unwillingness of investors or managers to be convinced by a new development in the market but, having been convinced, their subsequent unwillingness to admit error is a major factor in the volatility of markets. The lesson we must derive is always to retain an open mind to new themes and developments in markets, and not to become set in our investment ways.

** 'Identifying real skill and behavioural weaknesses in the active management industry.'* Rick di Mascio – Inalytics Ltd. 2005

Reflections on 30 years of UK Inflation

Thirty years ago, the annual inflation rate in the UK was running at over 26%, whilst unemployment was rising relentlessly towards a then post-war peak of 1.5million. For the editor, preparing to take his A-level Economics exam, this was a puzzle. The text books of that time all dictated that for economic

policymakers in the developed world there was a trade-off between unemployment and inflation. An observed lower level of unemployment was consistent with a higher level of inflation, and vice versa. There was a neat graphical illustration of this phenomenon, known as the Phillips curve, which had held good for many years. The possibility of both unemployment and inflation rising at the same time produced points well off this line so the problem was – what to write down in the exam? The old theory or the new reality?

The reality of such a level of inflation was not academic for those living on fixed incomes, especially the elderly. For those who had borrowed heavily in the previous few years to enter the property market, however, there was a remarkable benefit. Although interest rates had risen to a post-war record level of 14%, the galloping increase in the level of prices meant that in real terms the monetary value of debt, and particularly mortgage debt, was shrinking remarkably quickly. The domestic property market was stagnant in price terms, but there has seldom been a more attractive time to borrow heavily, as real interest rates were massively negative. By comparison, the recession of 1989-1992 was extremely painful for heavily indebted mortgage payers – nominal interest rates remained at 15% from 1989 until the ill-timed entry of sterling into the EMU whilst real interest rates were rising sharply and underlying property values falling.

Today, both retail price inflation and interest rates are at seemingly incredible low levels compared with the experience of the 1970s and 1980s and the property market is also relatively subdued. Is the inflationary beast dead or merely sleeping? It all depends on where you look, and certainly on some partisan measures it appears that inflation has lately been in rude health.

It was interesting to see a news item concerning an alleged collusion involving 50 well-known public schools and the fees that they have been charging for the past few years. Parents who have been subject to rising annual fees which bear no relation whatever to the official rate of inflation may not shed too many crocodile tears. Another report made a comparison between the prices charged in 1996 for admission to a number of well-known tourist attractions in and near London, and admission prices today. Top of the list was Madame Tussaud's, admittedly last visited by the editor sometime before decimalisation, where entry cost £8.75 nine years ago. Astonishingly, a visit to the waxworks is now £23.99, an increase of 174%

over nine years. Over the same period, depending slightly on the measure taken, the overall retail price index is up by between 25-30%.

Is Madame Tussaud's six times better since 1996? Well, maybe. There are still queues outside so presumably the market is relatively price insensitive. How are you going to get there? Well, you could go on the Underground, but from January a trip in the Central Zone in London will cost you £3. The editor remembers that when he had a holiday job in London in 1977, a similar trip cost 8p. Is the tube that much better value? Possibly not.

The point is that it is all very well to discuss inflation in general terms, but when the issue is what you, a consumer, actually pay then the perspective is somewhat different. Inflation, despite whatever published figures are put out by the government, is essentially a subjective measure. Everyone has their own perception of how much their own personal basket of goods and services is costing them and will tend to be sceptical of any data which informs them otherwise. Smokers, heavy users of domestic fuel and petrol, council-tax payers, aspirant property buyers in London and parents of children at private schools simply will not accept that inflation rates are at anything resembling published statistics. Interesting, too, that companies such as BP, Shell and Total were apparently not actively planning for the potentially inflationary surge in world oil prices that we have seen over the past year or so, given that so few petrol stations are able to cope with a display price of over 99p on their forecourts – a price thankfully not yet reached (except in the farther reaches of Scotland) but not altogether fanciful.

What has undoubtedly happened is that prices of goods which are purchased less frequently, such as electrical goods, personal computers, cars and clothing, have fallen in price both in nominal and significantly further in real terms. The deflationary effect of these price falls has compensated for rises in goods and particularly services purchased more frequently. Council-tax payments, together with energy and utility bills, fall into this category, as do the examples mentioned above. The perception is thus of a higher rate of price increases than statistically is the case.

Does this matter? In the heavily unionised world of the 1970s and early 1980s, the perception of rising prices led to pressure for higher wage claims backed by the threat of strike action. Even as late as 1981, the

Thatcher government had to concede an inflationary wage claim by the National Union of Mineworkers in order to avoid a damaging strike. Today, however, the ability of labour to press for wage claims above the level of published inflation is almost non-existent, apart from niche groups such as London Underground staff. It would thus appear that demand- or wage-led inflation is not a major threat. However, where we do see inflation as more of a threat than many other commentators or fund managers is from the perspective of rising costs – particularly of imported goods or raw materials. We envisage a period of weakness for sterling against the dollar and especially against most Far Eastern currencies. A fall in sterling and a simultaneous rise in the Chinese yuan would offset to a large extent the helpful influence of falling finished-goods prices imported from the Far East. Raw materials are also generally priced in dollars, and contrary to the expectation of many commentators a year ago, the dollar has risen against sterling by 10% during 2005.

No return to 1975 then, or even to the early 1990s. Nevertheless, it would be a mistake to dismiss the pernicious ability of even low levels of inflation to erode the real value of capital over time, which is why, at the moment, we remain firmly in the camp of holding equities over bonds as our asset of choice for most of our clients.

Avoiding the next Pensions Crisis

In recent years, the City's reputation as the preferred manager of pension assets has suffered more than a few dents. For some, the shenanigans of the life assurance companies have had very painful repercussions and, not helped by the fact we are all living longer, people's confidence in corporate pension schemes has also taken a knock. The institutional approach to managing pensions relies on individuals managing a particular asset class, eg UK equities, Japanese equities, commercial property or a currency overlay. Managers are totally divorced from the asset allocation decisions and even more divorced from the ultimate beneficiaries – the pensioners. But how well placed is the City for the next generation of pensions, the SIPP (Self Invested Personal Pension), and how do we avoid another pensions crisis?

SIPPs have been around since 1990 but they are enjoying much increased publicity, mainly because many of the rules are changing on 'A' Day, 6 April 2006. SIPPs require pension advice, a SIPP provider

(the legal ‘wrapper’) and investment management either by the individual or by an investment manager. The increased flexibility of SIPP investment may make for interesting newspaper articles but residential property, fine wines and vintage cars are not natural SIPP investments. For those who outsource the investment of their SIPP, great care should be taken when selecting a manager. The good news is that the manager and the member or beneficiary (the client) can have a very close relationship. As with any private client/investment manager relationship, the manager should know the member’s overall financial circumstances. With SIPPs, certain information takes on significantly more importance: when is the member going to retire? What tax-free sum are they going to take? When are the benefits to be taken? When will the Plan go into drawdown? And don’t forget, retirement plans often change.

SIPPs are one of the best examples of a type of investment portfolio requiring a “lifestyle” approach. The asset-class mix and the way the mix changes over time depend on many variables. Firstly, there is the risk you are prepared to take, which may in turn depend on the value of any other free assets which can support you in retirement. Secondly, at what age do you plan to retire? (And remember that many people continue to earn in retirement, either through consultancy work or working part-time, and may also be receiving a corporate pension). Thirdly, what is the financial position of a surviving spouse? These are just some of the questions that a SIPP-holder must answer.

SIPPs will normally contain the traditional asset classes of equities, bonds and cash but could have exposure to commercial property (either direct or through a fund), private equity, typically through a fund, and other alternative asset classes such as guaranteed products, hedge funds and structured products, the latter being an excellent way of protecting the downside.

You must select an investment manager who understands the expected returns from any given asset class and the level of risk to which each asset class is exposed. The investment manager must be able to combine exposure to different asset classes in the right proportion to achieve a desired level of risk and return and also change the asset class mix over time as the future liabilities become more imminent – that tax-free lump sum of £250,000 in 10 years’ time or that income requirement of £40,000 a year in five years’ time. If SIPP investment management is outsourced then make sure the manager is asking the right questions. Avoid your own personal pension crisis and ensure retirement really is the Nirvana you have spent your working life looking forward to.

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