

A VIEW FROM THE BRIDGE

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Whilst modesty is rather more attractive than boasting, I owe it to my colleagues to take this opportunity to tell you that Taylor Young Investment Management has been short-listed for two of this year's eleven PAM Awards. These are the "Oscars" of the Private Asset Management industry and to have been short-listed for two awards is a tremendous achievement. The two categories are firstly, Image and Reputation – Boutiques; and secondly, Investment Performance – Growth. The Chairman of the Judging Panel said "more firms than ever before entered the PAM Awards this year...and despite the fact that we tightened the entry criteria in a number of classes the overall standard was higher than ever across the board". We are one of only fifteen firms nominated across the eleven categories.

The first three years of this Millennium were very difficult years for equity investors; the second three years have proved more rewarding. What the next three years has in store: only time will tell. However, at certain points in Stockmarket cycles, some argue that a "value" style outperforms a "growth" style; at different points, others argue the opposite. As our clients and regular readers are well aware, Taylor Young has a thematic approach and our first article sets out where we stand in this growth versus value debate. Our second article is another in our series of behavioural finance. We respond to a view of the seven sins of the buy side (ie us, fund managers).

Whilst we would be wrong to flatter ourselves into thinking that the Chancellor might have read our last edition of "A View from the Bridge" where we said "the increased flexibility of SIPP investments may make for interesting newspaper articles but residential property, fine wines and vintage cars are not natural SIPP investments", we were not expecting a u-turn. However, the change of heart is perhaps a timely reminder that pensions must be taken seriously. At least one leading life assurance company managed a total return of 4% in 2005, less even than sterling cash or UK gilts, and significantly less than UK equities, overseas equities, commercial property or any major asset class one cares to think of. One cannot afford to be so distanced from the investment strategy that will dictate the quality of your retirement and our third article argues that a SIPP portfolio should be the most personalised of any mandate.

Finally, for the third and last time I would urge all to review their pension arrangements ahead of "A-Day", the 6 April 2006.

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'Value' & 'Growth' Stocks: A Thematic Approach

Every year, the financial press carries a number of articles from fund managers extolling their own particular investment style and the portfolio of stocks they tend to favour. Recently, there have been a number of articles suggesting that a 'growth' style is now being favoured over a 'value' style, and that managers who have a bias towards 'growth' stocks are likely to perform better than those with a bias towards 'value' stocks. Some managers muddy the waters even further by using the term 'favouring' stocks, i.e. those that offer 'growth at a reasonable price', thus neatly trying to place a foot in both camps. It is a very reasonable question to ask what these concepts actually mean, and why we at Taylor Young adopt

what we call a 'thematic' approach to investment, neither overtly favouring 'growth' or 'value', but aspiring to be pragmatic in our approach to buying and selling shares, bonds and funds in a rapidly changing world, and seeking to invest in companies and countries set to benefit from economic, social and technological change.

Essentially, a 'value' style aims to buy stocks that trade at a low premium to their net asset value – whether represented by fixed assets, such as property and machinery, cash or other tangible investments – and which often pay a higher dividend than the market average. It is often the case that such stocks are in mature industries such as engineering, food manufacturing or tobacco, and often are unfashionable either in terms of their corporate image or the goods

they manufacture. The virtues of such companies, it is argued, tend to be overlooked by market participants on a day-to-day basis but over time the solid virtues of regular and growing dividend payments, backed up by a reliable stream of profits, will come to be recognised in terms of a steadily appreciating share price, regardless of swings of sentiment in the rest of the market.

There is a good deal to recommend in this stance, and indeed a number of stocks with these characteristics are to be found in our current portfolios. The key point that we would stress is the importance of dividend income, and most particularly the re-investment of dividends received from shares back into the market. Over the very long term, the returns derived from such an approach have been remarkable. Since 1900, an investment in the UK stock market, ignoring dividends, of £100 would be worth around £14,600 by the end of 2004. This represents a compound growth rate of around 4.8% per annum. However, if all dividends received from this investment were reinvested back into the market, the annual average compounded growth rate would have been slightly more than double, at 9.7%. Over 104 years, this would amount to a total of £1.8 million.

So it seems there is no argument – buy ‘value’ stocks with a high and growing dividend stream and then wait. **Not so fast.** The statistics are misleading insofar as very few companies have lasted in anything like their current form over the past 104 years. Companies start up, merge and get taken over or fail, and so over the very long term the indices which represent the total market change radically. Holding on to the largest companies in the market in 1900 would have resulted in a portfolio dominated by railways, textiles and minerals, nearly all of which would have suffered through nationalisation, slump or declining markets over the period. A thematic approach to investment would have avoided at least some of these pitfalls, but let us first consider the case for a ‘growth’ style.

A ‘growth’ style manager would argue that the market tends to undervalue companies in new and emerging industries as it focuses too much on the short term. Twenty years ago, mobile telephones were as heavy and bulky as a building brick, their use restricted both by cost and portability. The size of modern mobile telephones, new applications such as texting and ring tones, and the relative affordability of the technology has fostered the development of huge companies such as Vodafone. In the United States, the spread of personal computers and the hugely increased power of

microchip technology has seen the emergence of dominant companies such as Intel, Microsoft and Cisco, whilst previous corporate titans such as General Motors and Ford struggle against fierce competition from the Far East. Investment at an early stage in emerging industries can surely, then, reap huge rewards, as growth rates outpace market expectation year on year; dividends are either not paid, or are set at a very low level as profits are ploughed back into the business to increase growth rates. If only you had bought Dell or Intel when they first came to the market and waited . . .

It is perfectly true that an early investment in a number of today’s household technology names would have been extremely lucrative over time. However, the memory of the technology boom and bust of the late 1990s is still very vivid and the fall-out from the unrealistic expectations of the telecommunications and Internet-related industries cast a long shadow on the world of the growth investor. Without profits, and with no dividend support, share prices in a large number of so-called ‘growth’ stocks crashed abysmally in the years between 2000 and 2003.

So why ‘growth’ stocks now? Well, after the turmoil of the past five or six years, the scepticism and risk-aversion of investors towards these stocks has caused them to come back to valuations where, some would argue, the market again underestimates their potential for future growth. Earnings and profits might again surprise, but this time on the upside.

Our ‘thematic’ view is essentially pragmatic; we can see virtues in both arguments and invest in both ‘value’ and ‘growth’ stocks in our client portfolios. However, there can be no one-size-fits-all approach; interestingly, Vodafone, often classified as a key ‘growth’ stock, could now, by virtue of its dividend yield, qualify on some grounds as a ‘value’ stock. Tesco is showing strong growth in its own market segment, but the food retailing sector itself is hardly at the forefront of the ‘growth’ universe. Categorisation and classification become somewhat more difficult than first thought.

So, to sum up: we stand back a little from the ‘growth’ versus ‘value’ debate. A thematic approach seeks to apply the disciplines of both styles to construct robust portfolios for our clients, providing both income and capital growth on a bespoke basis, depending on each client’s particular appetite for risk in the market.

Whilst Everyone Else Was On Holiday..

One of the benefits of manning the office in the period between Christmas and New Year, apart from the undying gratitude of absent colleagues, is to catch up on reading some of the large documents from brokers and other investment houses that arrive every day in our post. Some of them are 'time-critical', in that their subject matter is quickly overtaken by events in the domestic economy or in global markets; others contain material that does not impact greatly on or have relevance to the investments that we manage on behalf of our clients. A few, though, have a more timeless quality and it was one of these that the Editor found particularly engrossing one gloomy and cold late December afternoon.

Seven Sins of Fund Management: A Behavioural Critique was published by James Montier of Dresdner Kleinwort Wasserstein last November. It encompasses a number of themes that have been discussed in previous editions of *A View From The Bridge*, adding new perceptions to a number of them. It is perhaps symptomatic of the information overload that is endemic in modern financial markets that this worthy document had somehow burrowed its way down to the bottom of the in-tray; nevertheless, the importance and controversial nature of some of the arguments do, I believe, merit examination, which will in turn make us better at our job of managing investments and increasing the wealth of our clients.

One 'sin' we can agree with whole-heartedly: there is a surfeit of information in financial markets, the 'sin' being to believe that more necessarily means better. Whilst economic data and company annual, half-yearly and quarterly announcements appear on a predictable and regular basis, the quantity of opinion and interpretation of such data seems to rise almost exponentially every year. It is almost the reverse of the old press adage, 'comment is free, but facts are sacred'. Often it is a case of 'making the facts fit the view' – manipulating data in order to fit it into a particular investment case or economic viewpoint. Highlighting certain figures or issues and downplaying others can do the job quite effectively, and whilst there is doubtless no sinister intent behind any of this, often the more one reads the less one understands.

Two other sins – those of giving greater credence to so-called investment 'stories' rather than hard facts, and operating under very short time horizons – are also, in our view, entirely valid. A fourth, that of the

collective over-confidence of managers in their ability to out-perform markets or set benchmark targets, also seems sound; when polled, a clear majority of managers will be confident of their ability to out-perform, yet statistically this cannot be the case. At least some of them must be wrong, and their self-confidence better termed as hubris.

Montier also makes a good case for the 'sin' of putting too much faith in forecasts. Individual forecasters have empirically little skill in predicting future events. There is also an incentive for individuals not to stray too far from what are known as 'consensus' expectations for fear of ridicule or, worse, losing one's job for being wrong. Mavericks may, of course, sometimes be right but in the world of forecasting, as Keynes has acidly noted, 'it is better to fail conventionally than to succeed unconventionally'. A cynic might, of course, argue that those who *are* any good are too busy dealing on their own account from their private planes or ocean-going yachts to bother with writing anything for the benefit of other investors, so perhaps we do not see the entire picture.

A more debatable 'sin' is the lack of value in meeting the managements of companies in which a fund manager is invested or in which he is minded to invest. Managements, it is argued, will only present information about their companies in an asymmetrical way – highlighting positives and downplaying negatives. There is also a dynamic in the meeting format for tacit acceptance of what is presented – no one really wants a row – and a number of psychological studies support the hypothesis that most people find it hard to question the credentials of so-called 'authority' figures – in this case the company management. Far better to do the work from published material. But this 'sin' of spending a lot of time meeting managements who present less than objective views is less clear-cut: it is surely the responsibility of the fund manager to form his own view of the prospects for a company from a number of sources, and meeting management often serves to confirm either prejudice or favour.

The last 'sin' is also, in our eyes, slightly questionable in that it casts doubt on the validity of investment decisions taken by groups or committees. In a previous edition of *A View From The Bridge* we cited an experiment whereby a number of individuals were asked to guess the weight of a cake. Although some guesses were close, and some quite a way off, if the returns were aggregated and then divided the *collective* result was very close to the cake's actual

weight. Montier argues that there is a tendency for ‘groupthink’ in investment decision-making, and that a ‘consensus’ or ‘least controversial’ decision whether to buy, sell or hold a stock reflects an easy option, most likely to be wrong. Undoubtedly, it is the case that inflections or turning-points in markets or stocks are remarkably unobvious at the time, and only appear so in hindsight. At Taylor Young, though, we incline to the view that the widespread collective experience of our individual managers adds rather than detracts from our investment processes and decision-making and thus would favour turning this last ‘sin’ into a ‘virtue’.

Overall, though, a fascinating, thought-provoking and original piece of work. Perhaps it will lead another commentator to produce the counter-study: *Seven Virtues of Fund Management*. Now that would be interesting . . .

SIPPs and Life’s Personal Cycle – The Architecture of Bespoke Solutions

The major changes to pension regulations being introduced shortly on A-day (this being 6th April 2006), will have a very significant impact on the Self Invested Personal Pension (SIPP) market. We anticipate **a major acceleration in the growth of SIPPs** motivated by changes such as the ability to make contributions up to 100% of earnings (subject to the cap), greater income drawdown flexibility, and a relaxation of compulsory Annuity purchase at age 75.

From an investment perspective, the desire to achieve specific pension needs requires clarity of purpose and a detailed understanding of how strategies can be constructed and used to achieve what is very often a highly bespoke requirement. For many, their pension fund is one of their largest assets.

For the vast majority of SIPP portfolios, **a life cycle exists** which is determined by **specific events**, often driven by **personal circumstances** that can result in a change of objective, expectation, timing or even purpose. The result is that SIPP portfolios can become **more sensitive to investment volatility** and this, in turn, leads to the need for a modified investment mandate. If, for example, a known event is drawing closer in time, then there is a natural desire to replace what may be a high degree of uncertainty with a greater degree of conviction thereby moving to a more risk-averse strategy.

Simple examples of phases that affect many SIPP portfolio strategies are the initial total return phase in the investment cycle, this can often be followed by the lead up to a period when an income is withdrawn from the fund, perhaps followed by a period when income is then withdrawn on a regular basis, and then the period leading up to an annuity purchase or perhaps an alternatively secured pension arrangement.

One can quickly see that there are many potential phases in the long-term management of SIPP assets and that **a regular review of each personal mandate** is both desirable and, it could be argued, indispensable. Further, it is necessary for mandate managers to respond to the challenging needs and individual requirements that these reviews present.

The architecture of an investment manager’s bespoke solution will increasingly require sound pensions investment knowledge, advice, regulatory awareness, administration and the greater understanding of the specific life cycle of a SIPP mandate when coupled with the changing circumstances of the individual.

Concurrently, one must be particularly mindful of the **movement in the level of long-term interest rates**, as the life of a SIPP unfolds, as this can have a severe effect on both the expected and the actual income levels produced by portfolios of this nature.

An appropriate investment process designed to accommodate all of these requirements, coupled with sustainable and consistent investment performance which seeks to meet individual expectations, requires **an architecture that is flexible**, agile, and clear and this in turn must be supported by **good communication** between an adviser and their client. Continuous dialogue, as *life’s personal cycle* evolves, is essential.

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