

Graham Bentley puts the recent stock market turbulence into context.

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lessons from the past



Those who cannot remember the past are condemned to repeat it.

George Santayana



We've been in a quarter-century bull market since the outset of the 'great fall' in interest rates and inflation that started in 1982, and which led to the excesses of the 1980s (eg Duran Duran) and the associated boom in house and share prices that extended (with the odd hiccup) through that decade and beyond.

This involved a more than 20-fold (2000%) rise in the FTSE All-Share DataStream Total Return Index. For many less-mature observers this will certainly feel like the worst market ever, and perhaps we are all going to hell in a handcart. The UK All-Share Index is down 42% over the last year, with a more than 23% fall in the last four weeks*. This is not unprecedented, however, and I'd like to give you a brief description of the worst period in UK stock market history, when some current market commentators were still in short pants.

In 1973, following the US withdrawal from the Bretton-Woods agreement on fixed exchange rates and the subsequent devaluation of the dollar, the world was on the brink of global recession. Property prices in the UK had plummeted, and interest rates hit 13%. The secondary banking crisis saw 30 banks bailed out by the Bank of England as property values plummeted below the value of loans (ringing any bells yet?). Through the autumn of that year, OPEC's Arab states refused to ship oil to supporters of Israel (US, Western Europe, Japan) during the Yom Kippur war. They also increased prices to counteract the effects of the devalued dollar. This effectively quadrupled the real price of crude oil at refinery level (after 100 years of stable oil prices), while causing massive shortages in the US.

In the UK, coal miners were already 'working to rule' (younger readers, this meant no overtime, favours to management etc.) and stocks of coal

had dwindled. The Tory Government introduced the three-day work order, which limited commercial consumption of electricity to three days a week. In the spring of 1974 Prime Minister Ted Heath went to the country (for an election, not a weekend away) but lost. However, Labour did not have an overall majority, resulting in an ineffective Government until a subsequent election in October that year. Global recession due to the oil price shock and lack of political leadership led to a stock market fall of over 33% between May and August 1974, and over 60% over the year ending 25 November 1974. So what, you might say?

Well, the 'so what' is that when all seemed lost and the handcart was being loaded, the market went up by over 11% in a single day (24 January 1975) as institutions recognised the extent to which stock had been oversold. By 10 February 1975 the market had posted a gain of almost 82% in four weeks. Over that wonderful year of 1975 (inspiring, to some degree, my decision to enter this exciting industry later in 1976) the market rose almost 160%. An investor with £1,000 in November 1973 was worth £389.43 at the bottom in November 1974. By 6 January 1976, just over a year later, he was worth £1,009 – and these are capital prices that don't even include reinvested income.

don't follow the herd

That period (amongst others) provided a lesson to investors that we are wise to listen to today. The doyen of 'old school' investors, Warren Buffet, is probably the most successful investor in history and his approach to investing has not changed in over 50 years. According to Buffet, in the short term, the market is a voting machine – what are the majority doing? This is well illustrated by the following story**.

An oil prospector went to heaven. St Peter said, 'Well I've reviewed your life and you've ticked all the boxes, but there's a problem. We have tough residency laws up here, and we keep all the oil prospectors over in that section. As you can see it's full and we have no room for you.' The prospector replied 'Do you mind if I just say four words?' St Peter responded 'Certainly, why not?' So the prospector cupped his hands and yelled, 'Oil discovered in Hell!' To a man, all the prospectors headed straight down. St Peter said 'Neat trick, it's all yours now so go and make yourself at home.' The prospector paused for a minute, and then said, 'No, I think I'll go along with the rest of the boys – there may be some truth to that rumour after all...'

weigh up your options

In the long term, however, Buffet suggests that the market is a weighing machine – where, and what, is the value? Equities should be attractive because they introduce investors to a company's profits, distributed as dividends. We expect those returns over time to be higher than interest on deposits, to compensate us for the risk of the company going out of business. What you're doing when you invest is deferring consumption and laying money out now, to get more money back at a later time. There are only two questions – how much are you going to get back, and when?

We're all familiar with the phrase 'a bird in hand is worth two in the bush'. That isn't always the case. As interest rates vary, the value of all financial assets changes as if the price of birds had fluctuated – that's why sometimes, the two birds in the bush are better than the one in hand. In periods where interest rates are low, the bird in hand (ie cash) is unattractive and so everyone chases the birds in the bush, ultimately driving prices to nonsense

levels. Sometimes of course, events occur to make us reconsider that decision – as with now, the bird in the hand really does feel like the safest bet.

Let's think, however, about the real (as opposed to apparent) value of those birds. A simple rule of thumb about how attractive the stock market is at any time relates to dividends. When the market's average dividend yield (ie dividend payment per share divided by the share price) is 3% or less, the market is considered expensive - the birds in the bush are too expensive per bird and not worth waiting for, when I can 'spend' the bird in my hand. When it is 5% or more, it is time to buy – the two birds in the future are worth so much more, it is worth me sacrificing the one I have, in order to wait for them. Unfortunately for investors, equity yields at this level are very rare, and especially in times of low interest rates. I have some great news for you. Today (20 October), interest rates (the bird in the hand) remain relatively low – the yield on the benchmark Gilt is 4.7%. However, the yield on the All-Share Index is a remarkable 5.5%[†]. The last time we saw equity yields higher than Gilt yields was February 2003 – the bottom of the bear market followed four weeks later.

offering perspective

So what does Warren Buffet have to say about the current market calamities? In a recent article in the New York Times^{**}, Buffet explained to his American readers that during the Great Depression, the Dow hit its low, 41, on 8 July 1932. Economic conditions deteriorated until Roosevelt took office in March 1933. By that time, the market had already advanced 30%. In the 20th century, the US has endured two world wars, Korea, Vietnam and Iraq; the Depression; a dozen or more recessions and financial panics; oil shocks; a flu epidemic; and the resignation of a disgraced president. Yet the Dow rose from 66 to 11,497. In short, he said 'bad news is an investor's best friend', you can buy a cut-price stake in a country's future. Today people who hold cash (the bird in the hand) have opted for a long-term asset that pays virtually nothing and is certain to depreciate in value (even outside Iceland). Those investors who now cling to cash are betting they can efficiently time their move away from it later.

However difficult it might feel, don't panic. To use a football analogy, a good striker will tell you they move to where the ball is going to be, not where it has been. That's the art of investing too. :

income opportunities

To emphasise the importance of yield, £1,000 invested in the FTSE All-Share Capital Index on 1 January 1982 would have risen to £9,529 by 29 December 2000. However, if you'd reinvested the income, your £1,000 would have been worth £20,850[†]. In other words over half the return came from reinvesting the income. This is an old story but, given the yield on the market today, becomes a remarkable opportunity.

You can read more on income opportunities from Liontrust, M&G, Skandia Investment Group and F&C on the following pages.

[†] 12 months, and four weeks, to 16 October 2008 Source: Datastream, Skandia Investment Marketing

^{**} After Benjamin Graham and Janet Lowe, *The Rediscovered Benjamin Graham: Selected writings of the Wall Street Legend*. New York: Wiley, 1999.

[†] Financial Times 21 October 2008

^{**} Warren Buffet, *Buy American*. I am. New York Times, pA33, October 17 2008.

[†] Source: Datastream. FTSE All Share DSTR index, 1 January 1982 to 29 December 2000, +2085%, FTSE All-Share (Capital) Index + 952%.

clear investment choice

In this issue of **informer** we have updated the categorisation of our fund lists to make the investment choices available to you and your clients via Skandia clearer.

The role you play in providing investment advice for your clients is crucial and it can also be complex and difficult. Skandia aims to simplify this task by providing you with a wide range of investment tools and fund solutions that enable you to meet your clients' individual investment goals.

With our sophisticated suite of investment tools you can work with your client to determine their individual risk profile, match an asset allocation to this risk profile and then build a personalised portfolio which can be monitored and changed as their personal circumstances evolve over their lifetime.

In order to provide greater clarity to the types of fund solutions available through Skandia, we have updated our investment model graphic (opposite) and the subsequent categorisations for the fund listings within **informer**.

what has changed?

You will now see a definitive split between MultiManager solutions and the Self Select range of 'single manager' funds within the fund performance lists. The MultiManager sections of fund listings have been split by those available from Skandia and those available from external fund managers.

In addition, a new page has been added to explain the range of fund solutions available through Skandia Investment Group – turn to page 24 for full details.

Details of the Spectrum Funds – Skandia's range of risk-rated funds that allow you to match the appropriate fund to a client's acceptable level of risk – continue to be available on page 25.

Royal Skandia

The Royal Skandia Sterling fund performance pages are no longer included within the UK edition of **informer**. However, these continue to be available online through **international informer** at

www.royalskandia.com/funds/informer.asp

If you have any feedback about these changes please do let us know by e-mailing informer@skandia.co.uk

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