protecting against the downside

August 2010

Graham Bentley considers the need for capital protection.

"The borrowing has to stop. The market slide was a shot right between the eyes that had better wake us all up to the simple fact that we can't keep romping forever on borrowed money."

Lee Iacocca, Chrysler Corp Chairman 1978-1992

You would be forgiven for guessing that the above statement was made in 2009, as Mr Iacocca saw his former company file for Chapter 11 bankruptcy (along with the loss of his company car). The quote does have that 2008, post-Lehman ring about it, doesn't it? In fact, he made that statement on 20 October 1987, the day after the crash. It might surprise you to learn that our current and ongoing angst concerning indebtedness is nothing new.

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>> You might even recall Alan Greenspan, Federal Reserve Chairman, in a speech to the American Enterprise Institute in late 1996, coining the phrase 'irrational exuberance'. He was commenting on the inverse relationship exhibited by price/earnings ratios, the past rate of inflation, and the 'undue escalation' in asset values that ultimately proved to presage the dot com bust in 2000. That bubble had been growing since the early 1980s, as rapidly falling interest rates and inflation created conditions where borrowing was ever easier – the lenders saw little risk of default, and the value of any underlying security for that debt was rising inexorably. It burst spectacularly in 1987, but re-inflated after the recession of 1992.

The last 10 years have seen the main developed markets underperform Cash. Emerging Markets, whose economies were less exposed to western-inspired debt, have been the equity exception. Cash, Bonds and even Property (in the UK) gave positive returns over that period. Markets have range traded for months as fears continue to be raised concerning problems with sovereign debt, and another recession (ie the 'double-dip'). A recent J.P. Morgan report has highlighted the fact that in the US confidence is falling, resulting in a number of economists cutting their GDP growth forecasts to around 2% – the consensus having been over 3%. The report tells us that monetary growth has slumped around the world, additionally citing the fact that the Baltic Dry Index – a measure of the cost of shipping – has fallen over 80% from its 2008 all-time high; such low prices imply dramatically fewer containers are being shipped. Meanwhile, while the US two-year Treasury yield reached all-time lows of 0.59%, the writer of the report remarks that it leaves him with '...an uncomfortable feeling that the world economy is headed into deflation...prices are now falling on a two-year annualised basis for the first time since March 1956'*. This reappearance of a deflation threat is worthy of further consideration, particularly because of the part it is believed to have played in creating the Great Depression – a particularly ominous prospect.

Professor Irving Fisher, an economist who lost up to $10 million in the crash of 1929 (as JK Galbraith said, that's a lot – even for an economics professor), suggested that the key catalyst for the Great Depression of the 1930s was not the crash itself, but rather low interest rates and inflation, and consequent loose credit. This encouraged over-indebtedness, and associated speculation that proved ultimately unsustainable. Fisher believed there were a number of factors that could interact under conditions of debt and deflation, to create the mechanics of boom to bust, paraphrased as follows:

Following the crash of 1929, consumers and companies focused on debt liquidation and the requirement to raise capital led to the forced sale of assets. The paying-off of bank loans led to contraction of the money supply. Meanwhile, asset prices fell as demand fell, along with a yet greater fall in the net worth of companies, precipitating bankruptcies. There is a close correlation between consumer confidence and unemployment figures, as you might expect; contraction in economic activity led to cost-cutting and redundancy – unemployment rose and confidence slumped. As spending fell and banks collapsed (9,000 banks in the US went bust during the 1930s), those with money stopped spending – they hoarded it. Interest rates fell, but because prices and incomes fell by as much as 50%, interest rates effectively rose because the debts remained at the same nominal amount. With future profits looking poor, capital investment and construction slowed dramatically. Banks built up their capital reserves and made fewer loans, which intensified deflationary pressures. The liquidation of debt couldn't keep up with the fall in prices that it caused. That stampede to liquidate increased the value of each dollar owed, relative to the value of declining asset holdings. Paradoxically, the more the debtors paid, the more they owed. This self-aggravating process turned a 1930 recession into a 1933 great depression.

Ben Bernanke, the current chairman of the US Federal Reserve Bank and architect of the Fed's bank bail-out, is an acknowledged expert on the Great Depression, and adheres to the debt and deflation model that Fisher postulated. That in itself is a positive; while there are echoes of the 1930s around at the moment, it would appear that governments are learning from the lessons of that period. However, there are voices (not least the Labour Party) arguing that austerity packages like those being introduced by the UK's coalition Government might harm any recovery.

Where does this bleak outlook leave investors? Uncertain would be an understatement. I should add at this point that Skandia does not see evidence of hoarding. We have received significant inflows of new business through 2010, with £3.2 billion in gross sales during the first half of this year. A personal thank you, therefore, to each and every reader. That said it is also true that some investors might feel that any longer-term positive outlook might be tempered with some pragmatism in the short term. A significant fall in markets from here could cause great harm to investors' aspirations; many first time investors in Autumn 1987 and Spring 2000 stayed out of markets for years after the shock of a collapse. It is therefore worth considering the options available to add a layer of protection to client portfolios.

You will know by now that I am strongly in favour of building asset allocated portfolios matched to clients' risk profiles and their personal aspirations. Investors should then expect fluctuations in periodic returns, knowing that in the long term they should arrive at their investment destination with the outcomes close to what they might have expected. On the other hand, the investor might be my wife. Being a photographer, and therefore more at ease with vignetting than volatility, she is adamant that a capital sum she wants to invest for our three year

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old son's school fees should have an element of certainty attached to it. 'What about all these black swans you keep on about? What if a swan swims up when we're ready to pay down the fees?' she demands, as I calmly try to explain the benefits of long-term investment, while thanking my lucky stars I don't have to give advice for a living. I cannot say 'trust me, I'm your financial adviser', having 10 years previously recommended she sell a fund that had the temerity to rise in price over the thirty days following her disinvestment. In effect what she is saying is she wants more protection. Now protection isn't a bad thing. Considering that risk is probability (P) multiplied by impact (I), and given we live in a thatched house, I'm rather less interested in mitigating the basic risks like spilling a pot of paint on the carpet, than I am about my roof catching fire. The chances of my roof being alight are relatively speaking remote, but the impact is literally devastating. So I insure against that unlikely event because on that P x I equation, it's worth it. Regarding school fees, whatever my risk profile, I have to curb my enthusiasm and elect to have some sort of insurance against a 'tail event', ie one that is unlikely, but has huge impact if it does occur. The last 10 years have illustrated that markets may exhibit extremes of behaviour so I ignore that at my peril.

So when I have such a requirement, ie a liability target I dare not miss, how can I build a portfolio that fits my risk profile and performs accordingly, but limits my downside to a tolerable level? In other words how can I insure my portfolio against catastrophe?

More on that next month...

*Source – J.P. Morgan Global Multi-Asset Group – 19 July 2010.

Over the next two months in informer Graham Bentley will explore the various techniques and funds available to protect clients' capital. And starting on page 12 we have a section focusing on downside risk and absolute return funds.

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