for financial advisers only

do you believe in fairytales?

Graham Bentley
Head of Investment Marketing

March 2010

Trusting long-held investment assumptions could prove hazardous, as Graham Bentley explains.

"There is something feeble and a little contemptible about a man who cannot face the perils of life without the help of comfortable myths."

Bertrand Russell,
Human Society in Ethics and Politics, 1955

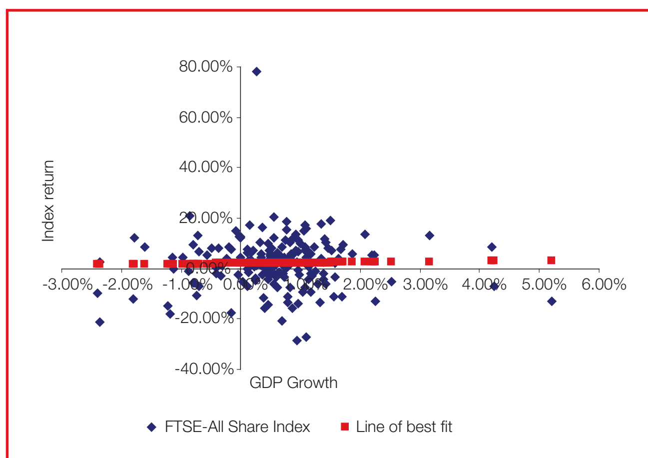
The eminent Mr Russell recognised that we have a tendency to reflect our unconscious desires by what we are prepared to believe based upon grossly insufficient evidence. We have a habit of criticising, and discounting evidence that goes against our instincts or beliefs, while being perfectly happy to accept a fact on the flimsiest of evidence, if it agrees with our view.

Through his famous quote on 'unknown unknowns' Donald Rumsfeld, if a little awkwardly, reminded us that we may not be aware of our lack of knowledge on a subject.

We have to have certain things which are axiomatic – immutable truths that underpin our understanding of the world. Unfortunately, there is very little in the investment universe that could be claimed to be self-evidently true. For example, you may be persuaded of the science of economics, and the eminence of a practitioner of that black art, by a prestigious award, say the Nobel Prize. Well strictly speaking there isn't one.

figure 1

Comparing UK stock market returns with GDP growth



Source: GDP versus stock market Growth – Office of National Statistics (ONS), Skandia Investment Marketing, data for calendar years 1962 to 2009 inclusive

figure 2

Gold price in sterling (inflation adjusted)

Source: Kitco.com, ONS, Inflationdata.com, Pacific Exchange Rate Service (PERS)

Alfred Nobel's will referred to prizes in Physics, Chemistry, Physiology or Medicine, Literature and Peace. Economics wasn't considered a science, and it was only in 1968 that the Bank of Sweden created a prize *in memory of* Alfred Nobel.

Economics has a 40 year history as a 'science', as far as I can see based on the fact that the theories are now explained using a lot of algebra. Some economists themselves have suggested economics isn't a science. A group of economists called the Austrian School has argued that economics starts with assumptions rather than observations and that economic theory is simply the logically deduced results of those assumptions. The chaotic events of the last couple of years have thrown economic theory into confusion, because the facts didn't fit the theory. This is because the theory may not be wrong, *but the assumptions might be*. Let's look at some assumptions.

ASSUMPTION 1:

"stock market performance correlates to GDP growth"

That statement seems so intuitively correct, that to argue against it seems futile; in fact GDP numbers should give us strong buying or selling signals were that the case. In the May 2009 edition of informer, I briefly drew readers' attention to the fact that there was little evidence of any long-term relationship between the two. Several studies have demonstrated that there is no statistically significant relationship between dividend growth (equity prices should only equate to the net present value of future dividends) and GDP. Taking the lead from those studies, I compared the quarterly returns on the UK market with the Office of National Statistics' own data on GDP growth, and in figure 1 you can see the result. Each data point is a particular quarter's GDP growth on the horizontal scale, coordinated with the market return in the same quarter on the vertical axis. If there was a relationship, you would expect the 'cloud' of blue data points to extend from the bottom left (eg negative GDP would equal negative equity returns) to the top right (strong GDP growth would match with correspondingly strong market returns). The red 'line of best fit' would similarly slope upwards. As you can see it doesn't, it is flat, suggesting there is no relationship. If you allow for a lag between the GDP figures of up to six months either side of their publication, more interestingly there is a weak correlation between stock market returns and future GDP growth – stock markets tend to want to predict GDP figures, and not the other way around.

There are a number of reasons why this might be the case. If equity prices are simply the net present value of future dividends, investors (as opposed to speculators) needn't pay attention to GDP numbers. Furthermore GDP is related to sales, while equity returns are to corporate profits. GDP represents the value of all goods and services produced in a country during a given year; it does not tell you how profitable they are.

For instance, in a price war a company might attempt to gain market share by increasing sales via a concomitant loss-leading price reduction. This would boost GDP, >>

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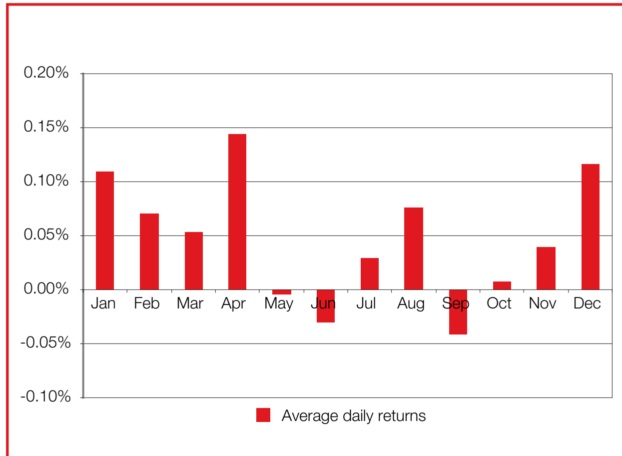
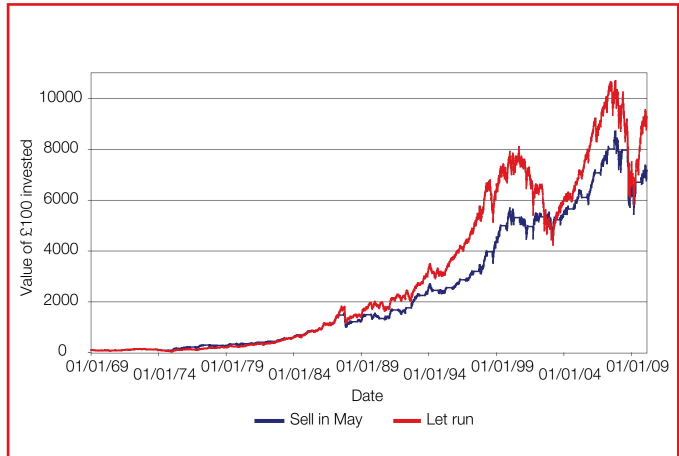
figure 3
FTSE All Share – average daily returns 1969-2009



Source: Financial Express, Skandia Investment Marketing

figure 4
Sell in May, profits away



Source: Financial Express, Skandia Investment Marketing

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but it might hammer the company's profitability and hence its share price. Multinational companies' profits may be earned outside the country in which they are listed; when the share price of Royal Dutch Shell rises there is no reason why that should reflect the GDP growth in the Netherlands or the UK. Being large companies, multinationals dominate their indices. Consequently, multinationals may exaggerate the differences between GDP growth and equity market returns.

ASSUMPTION 2:

"gold is an inflation hedge"

The current sterling gold price is fast approaching its all-time inflation-adjusted high of 1980. That period marked the end of a chaotic 15-year period known as the Great Inflation, and presaged what we have now come to call the Great Moderation, where interest rates and inflation plummeted through the next 20 years.

It was during the coincident oil-price crisis (and four recessions in the US) in the 1970s that gold gained its reputation for being an inflation hedge, but that period is untypical. From the peak in 1980 the inflation *rate* declined, but *cumulative* inflation climbed inexorably upward. Over the next 20 years the cost of living rose by 145% in the UK. Horrified? Well that equates to a constant inflation rate of only 4.6% per annum, a salutary lesson to anyone relaxed about their income requirements in retirement. Gold, meanwhile, rather than keeping up with inflation, saw its price fall from the peak of $850 (£364.80 at the prevailing exchange rate) per ounce on 21 January 1980 down to under $255 (£157.40) in July 1999 – a fall, before taking inflation into account, of 70% in dollar terms, and 57% in sterling (see figure 2).

This tells us Gold is not an inflation hedge – it is a 'crisis hedge'. Crises don't necessarily involve inflation; despite the credit crunch, we are not in the same league as the 1970s' hyper-inflation and global recession; on the contrary, evidence that the current recession is over is very visible across the globe (if less so in the UK). The price 'spike' has all the hallmarks (pardon the pun) of a bubble.

ASSUMPTION 3:

"sell in May"

You may have heard this before. Sell your portfolio on 1 May, and buy it back on St Leger day, usually the second Saturday in September, and you optimise your returns per year. This idea refers to the days when City toffs left their quill pens behind and journeyed off to the country for a summers huntin' shootin' and a-gamblin'. Clearly this is an anachronism isn't it? Some pundits continue to push this stuff, so we tested it (see figure 3).

On average, the worst month to be invested is September, followed by June and May. October, often peddled as the worst month (thanks to two crashes), isn't. Therefore, the logic goes, maybe this works? In reality, averages can be dangerous (see figure 4).

Since 1 January 1969, if you'd sold out of the FTSE® All-Share index every year on the first trading day of May, and bought on the first trading day following the second Saturday in September, £100 would be worth £7,168 as at 26 February 2010. If you had simply left it alone, you would have £9,377. The reason is that July and August positive returns have tended to outweigh a poor May, June and early September. So that proves it's a fallacy doesn't it? Well if you had put the sale proceeds in on deposit every year over that 138 days or so, you would have only needed a 2.5% annual interest rate for the sell in May strategy to work – *over that particular 40 year period.* So maybe it does work? Well, not necessarily, because we haven't factored in spreads, trading costs, potential CGT et al that would have to be borne by a trading strategy.

You may have noticed the outstanding returns experienced over the Winter, and particularly in April. This would suggest investing ISA monies at the start of the financial year, rather than at the end. However, in the main market timing is a risky business. Portfolio construction is best kept simple, matching client risk to portfolio risk and discounting clever ideas involving market timing – your clients won't thank you for believing in fairy tales...

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