

Managing an Uncertain Future (for Professional Adviser use only)



Much has been written on the spiral of debt-deflation in Southern European economies, the results of the UK election (is there really a mandate for electoral reform?), and the US market meltdown last Thursday when at one point 96% of open orders on the NYSE were sell orders. This is now well-trodden ground, and there is little value in adding to plausible-sounding ex post explanations, or analysing to something that may already be priced into markets. Instead we turn our attention to unexpected high-impact events that will cause *future* market fluctuations and volatility clusters.

Home on the range

The first consideration is the health of the world's largest asset class – US residential property. Prices there have done little more than stabilise, for the time being (see following chart), and the equity stake of homeowners is down to an all-time low of less than 40% - bear in mind that 96% of AAA rated mortgage backed securities issued in 2007 are now rated as “junk”. Furthermore, swathes of the population owe more on their mortgages than their houses are worth, for example two-thirds of mortgages in Nevada.

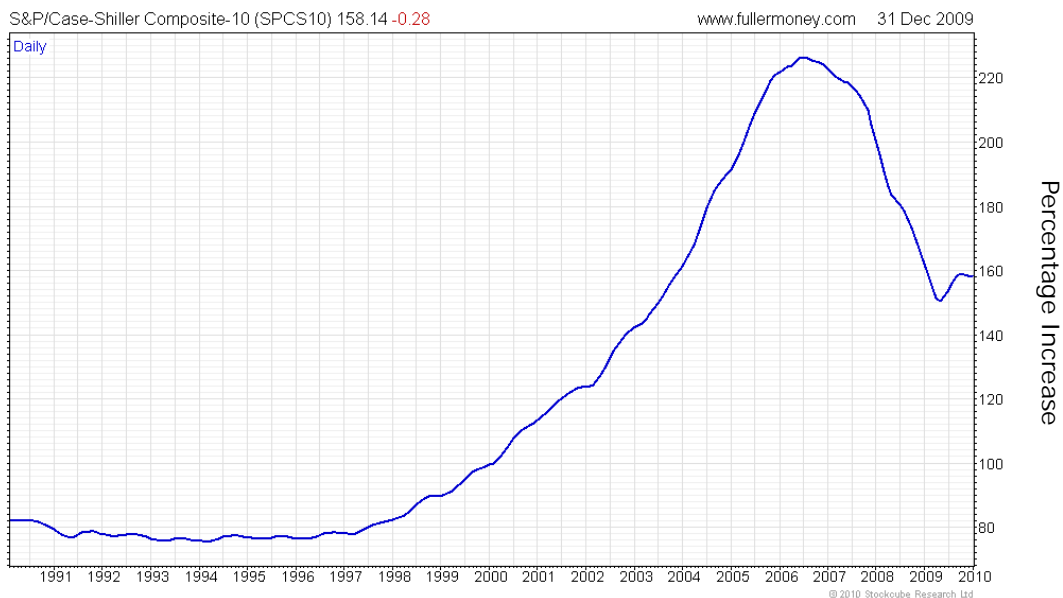


Chart courtesy of fullermoney.com

In some states such as California and Arizona, mortgages are “non recourse” loans, which means that defaulting homeowners have their income and assets protected from creditors. In fact in most states, in any case, it has proven more trouble than it is worth to chase down defaulting mortgage debtors. Meanwhile there has been a rapid increase in the number of “strategic defaults”, where a homeowner is able to maintain interest payments, but simply chooses not to.

If this becomes a more socially acceptable action i.e., perhaps if they know a friend, relative or colleague who has done it, then there could be a snowball effect as it would certainly make *financial sense* for many more to do so. And foreclosures continue to climb (see next chart). Clearly the end game we are concerned with is a negative feedback-loop in US house prices, which would take out most regional banks and many of the large ones too, and would likely see the world back in recession in short order.

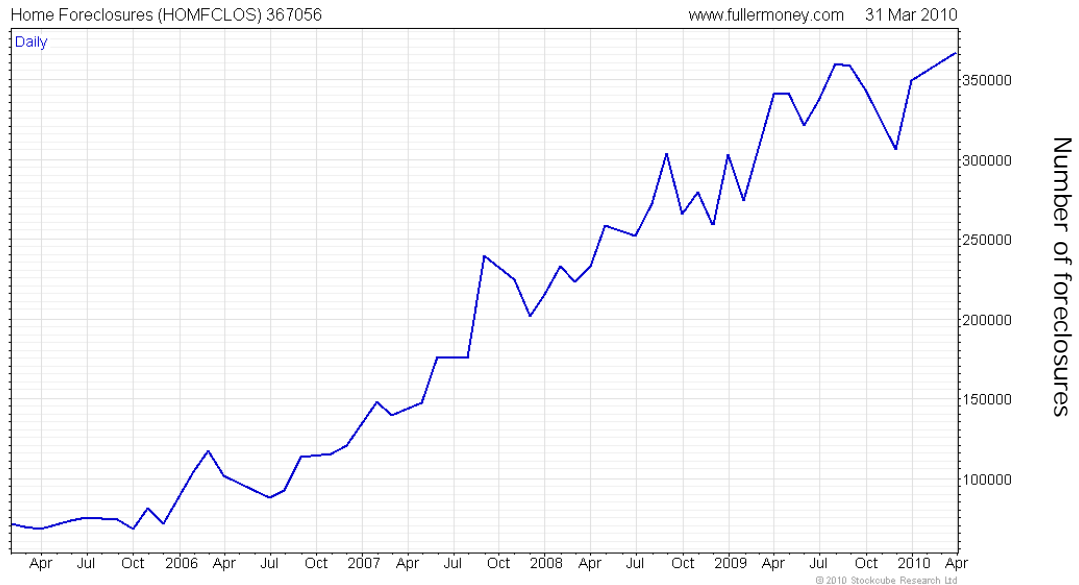


Chart courtesy of fullermoney.com

Still in the woods

We also believe that consumers may have “broken cover” too soon, in the US and the UK.

Retail sales are up in 11 of the last 12 months in the US, and the savings rate has collapsed back down to October 2008 levels. Unfortunately it is entirely possible that the economic coast is *not* clear, and a more frugal approach could have been appropriate - witness the US unemployment rate rising back to 9.9%, while the longer term unemployed rate has achieved new all time highs (records began in 1948).

Taxes are going to go up in both countries, the US likely being introduced to the delights of VAT, and government spending in the UK will rightly be severely curtailed.

In addition there are signs that the West may soon start to import inflation from Asia (UK CPI chart to the right), having enjoyed importing *deflation* for most of the last ten years.

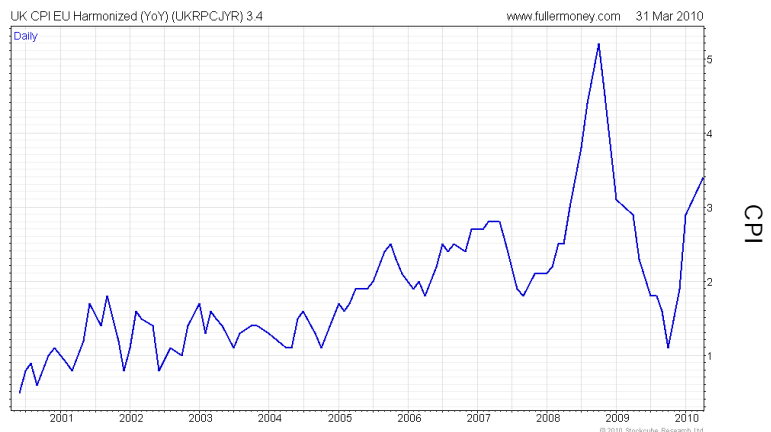
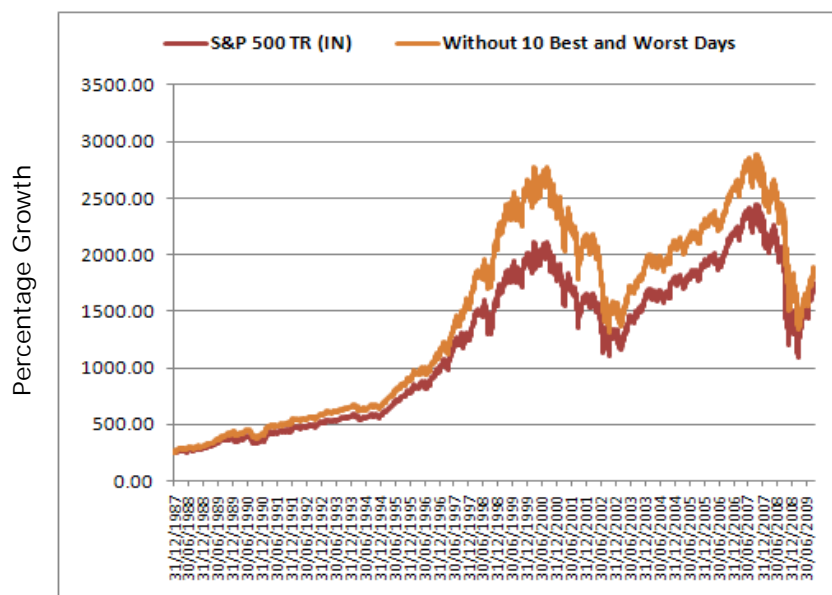


Chart courtesy of fullermoney.com

As the Bank of International Settlements (thought of as “the Central Bankers’ bank”) puts it: “In many countries employment and growth are unlikely to return to their pre crises levels in the foreseeable future.”

There was little joy in 2008 (or indeed now) in being proven correct in our long-held view that equities are more risky than investors generally perceive them to be.

This is particularly true for those who are involved in market timing - incidentally we have never come across anyone who themselves has ever come across anyone who can succeed consistently at this. The reason being that the stock market has a very small number of very large counter-trend days throughout its history, which somewhat dampen the roller-coaster nature of returns. However by moving in and out of the market you are liable to miss those very rare stabilisers, which means that you are trying to time a much more volatile beast than you realise, taking more risk than you perceive, and hence this is usually a value destructive exercise.



NOTE: You can see that by removing the 10 best and worst days makes the index *more* volatile, not less.

Source: Towry Investment Management Limited

The Towry Response

At Towry we have embraced the fact that we cannot predict an inherently unknowable future, and our client portfolios are therefore not dependent upon this.

Instead, we assess many thousands of possible versions of the future and our client portfolios are designed to perform through *all* conditions, with superior protection against volatility and market drawdowns.

We create truly global “man of the world” portfolios, investing in a diverse spread of asset classes and strategies, and with some of the very best fund managers.

In fact, we see more stressful conditions as opportunities as our process encourages and enables us to react objectively and unemotionally to market movements and changes in relative valuation.

To paraphrase Keynes, we try to be roughly right rather than precisely wrong, and always competitive. We believe that investment is more about what you don't get wrong than what you

do get right, and patience, persistence, objectivity, and a strong desire to avoid over confidence are in fact the successful investor's most important traits.

Behavioural finance not only gives us an insight into the rest of the market, but more importantly into knowing ourselves. This is crucial if we are to succeed in making the client experience as appropriately dull as possible!



Andrew Wilson
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If you would like to learn more, please contact your usual Wealth Adviser at Towry.

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