

The dogs that didn't bark...

The insight we chose to emphasise in our client reports three months ago was that, whilst both bond and equity markets had fallen and volatility increased, there was no persuasive evidence at that stage of any increase in investors' risk aversion. That would have been apparent had there been some reversal of the unprecedented compression in 'risk premiums' for credit risk (what poorer quality borrowers pay relative to good quality borrowers) and liquidity risk (what investors require as additional return for tying money up in investments with limited liquidity or no market prices).

Without signs that investors were rethinking their willingness to accept risk at an unusually low price, a rise in gilt yields could have been nothing more than a rise in inflation expectations and a fall in equity prices no more than a short-term correction. Indeed, during the last quarter, the inflation scare has receded with lower energy prices and signs (in the US) of some sanity creeping back into an overheated housing market. And equities are typically back to their spring peaks.

The other dog that did not bark was the currency markets. In spite of comments by China that it wants to diversify its foreign exchange reserves, there has been no real fear of any interruption to the massive financial flows into the US dollar that the regular haemorrhage on the trade account needs if the dollar is to avoid falling.

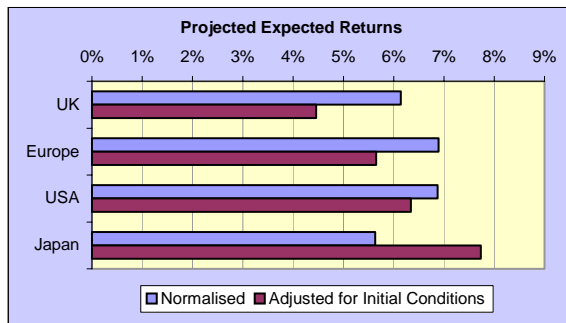
So correction it is, not a change of trend. Though nominal indices were by the end of the quarter mostly back to the highs they reached before May, and though these were already close to the levels reached in 1999 (on a 'total return' basis), the two are not of course comparable, as this ignores the sustainable long-term trend (typically around 6% pa) which in the intervening years has moved the target for a 'normal' valuation level up another 30-40%.

The position in the UK is apparent in the chart below (from the Lambda model), with recent cumulative index values calibrated on a trend from 1900 to date. The end point is 20% above trend.

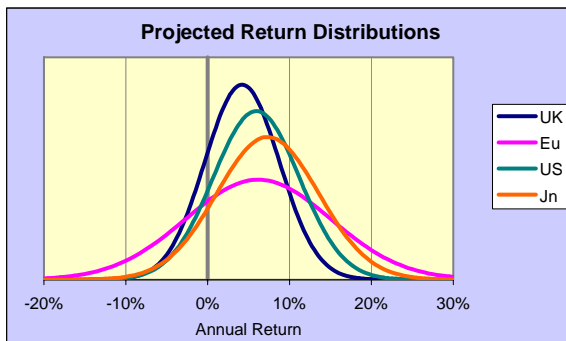


Unfortunately, even if we accept the historical evidence of real returns from major markets, there is no reason why bear markets should not start from a level of relatively modest overvaluation relative to trend. Indeed, the 1972-74 bear market in the UK started with a ratio of long term value not dissimilar from today's 120 (calibrated on data to that point).

The US position is only marginally different: its poorer performance from the bull market low has left it closer to trend than either the UK or Europe. Japan remains the only market below its trend.



Our current expected real returns (over a projection period of 10 years) for the four major equity areas are shown at left, with the 'normal' historical rate for comparison.



The shape of the distributions (below) illustrate both the degrees of uncertainty of outcome that equity markets must all be expected to show plus the adjustments we make for the difference in the amount (and quality) of data.

Thus the UK and US have comparable risk of projection error but the US has a slightly higher expected return.

Europe has a comparable return to the UK but much greater projection error. This reflects its shorter data history (from 1969) and also the fact that for part of this period there was no common currency and local currency return correlations were only

gradually increasing.

Japan has higher projection error than the US and UK and lower than Europe (we start the history in 1955 after the post-war reconstruction) but it still offers a high expected return.

The risk-adjusted returns, for the period appropriate to a portfolio, together with our estimates for covariance or correlation, are the inputs to the model that are reflected in the target allocations for the risky asset component of an Evidenced Asset portfolio and for the developed equity component of a Diversified Wealth Management portfolio.

Evidenced Asset Portfolios

In model-driven 'Evidenced Asset Portfolios', the combined equity exposure may be diluted by risk free exposure, depending on the level of risk aversion assigned to the plan. This risk-management approach does not require any judgement on our part about the medium-term direction of markets, as the discipline of objectively-measured risk premium (risky versus risk free) to the agreed planning horizon is more reliable than opinions about markets. Our observations about the economic and stockmarket cycles may be interesting but they are not what drives the portfolio strategy.

We can speculate what it is that might bring the bull phase to an end from a level at which equities are not greatly overvalued.

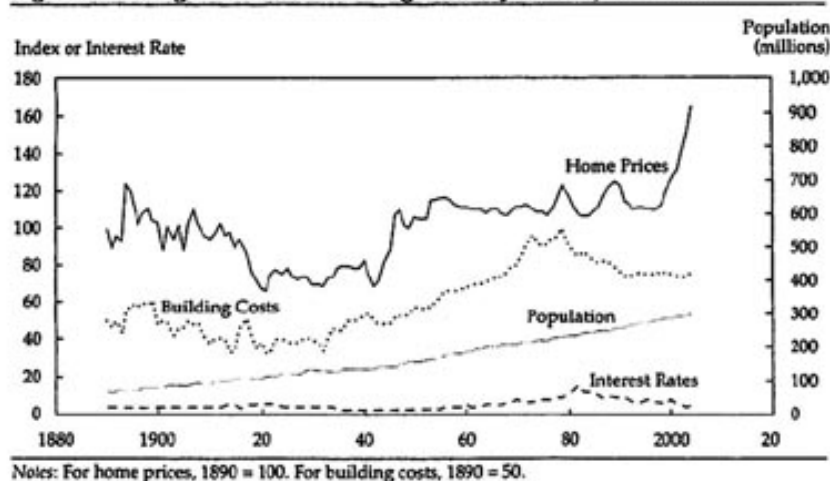
In fact we did this in our quarterly reports in January. The most likely cause is related to the cumulative economic 'sector balances' that have developed after some 15 years without a full recession – in other words a recession in which the balances between the main economic sectors (personal, corporate, government and foreign) are restored to more normal relationships. This might have happened at the start of the new century had 9/11 not triggered a massive injection of stabilising liquidity by the Federal Reserve Bank, thereby extending the growth phase of the cycle which at that stage was already a decade old. The cumulative effect is not so much apparent in the level of inflation as in the record government and foreign surpluses, lower personal surplus and exceptionally flush corporate sector. These US sector balances are mirrored in the UK.

The popular view is that low inflation is what has allowed central bankers to get away with this prolonged expansion and that it is China's role as provider of new low-cost production of traded goods that prevented the acceleration of inflation that would itself have ended easy money in the grateful consuming nations.

An alternative view is that it is the Chinese role in willingly accumulating dollar reserves that has removed pressure on the US to slow or reverse the steady drift into debt – manifested by the record trade deficit and the slump in personal savings. The latter is probably in part associated with the unprecedented boom in real house prices and it is this 'bubble' that is the main confirming evidence that 15 years of monetary expansion has caused inflation somewhere in the system. It looks like a serious error, with significant implications for the future conduct of policy.

In the graph below we show a long history for real house prices (deflated by general inflation) in America. Unlike the UK, we can see that for all but the immediate post-war period there has been no real growth in prices, but also quite small cycles. In the UK, since the Nationwide Index began in 1957, we have enjoyed a consistent upward trend of about 2% pa, with large cycles around it. The difference is not about building costs but land availability and planning restrictions. With no significant policy changes in the latter, the increase in US real house prices of over 50% from 2000 is most likely to have been sparked by easy access to credit and then fed by wildly unrealistic expectations so crass as to make even the UK's biggest housing bulls gasp.

Figure 6. Long-Term Trends In Single-Family Homes, 1890–2005



The source of the graph is a speech in February by Professor Robert Schiller (who created the index), author of 'Irrational Exuberance', the best-selling book about the dot com bubble.

America's budget and trade deficits and its looming problem in restoring normality to the housing market are all threats to the world economy, as well as their own. These adjustments will come, but we do not know when.

The significance of the stockmarket recovery in the last quarter is that investors have converged on the view that *it need not be now*.

Diversified Wealth Management Portfolios

For clients with 'Diversified Wealth Management' portfolios (combining public equities with other asset classes such as commercial property, private equity and commodities), our judgement *is* required. We emulate the modelled approach in the sense that we seek to answer the question of fundamental value before any question of timing.

Our judgement is that for property and private equity (particularly leveraged buy-outs) the expected returns are already cyclically very low and that the premium for illiquidity is inadequate. UK commercial property has fully made up its underperformance in the 1990s and yields are discounting unrealistic rental growth if the business cycle is not yet dead. Because we reject the notion that private equity returns, pre-leverage, are largely highly-incentivised returns to management skill, in favour of the view that they are mainly a leveraged bet on a change in the terms set in the public market for buying and selling equities, our cyclical view is bound to make us cautious.

We are avoiding bets much above or below the strategic allocation to commodities. Energy and metals have enjoyed a bull market for several years and are clearly sensitive to high growth in China but also whether there are a few more years left in the economic expansion phase in the developed economies. However, we are also mindful of a more secular view of trends in real (or relative) prices of industrial inputs which offers the possibility of a reversal of the 20-30 year decline in the terms of trade between producing and consuming nations. Both secular and cyclical trends in raw materials prices underpin the empirical evidence of low correlations between commodities and equities. This 'hedge' argument is important in meeting an overriding objective of the diversified strategy, which is smoothing the nominal short-term path of a set of returns that cumulatively will increase purchasing power at a rate comparable with equities.

One aim of these portfolios that follows from that objective is to hold assets or strategies that offer equity-type upside but with appropriately-timed downside protection. It is this aspiration, and the fact it was generally well met in the last bear market, that makes hedge funds popular with both private and institutional investors. Putting clients into a hedge fund can look indistinguishable from us delegating the timing decisions to a third party but it is actually more than that: we look for strong trading disciplines learnt over many years that include stop-loss rules. As ever, we retain a healthy scepticism about market timing skills - ours or anyone else's.

Both Evidenced Asset and Diversified Wealth Management portfolios are holding more in risk free assets than 'normal'. If markets continue to rise, we will cut back exposure to risky assets further, in the first case consistent with the client's goal-based model and in the second as a matter of judgement.