



Time to stand back?

Andy Gadd, Head of Research at Lighthouse Group, gives his view on the recent falls in share prices and reminds investors of some fundamental principles of investing.

Warren Buffet once said that you should be fearful when others are greedy and greedy when others are fearful – there is no doubt that fear is gripping the markets at the moment.*

This fear currently has two root causes. First if you had said to me at the beginning of the year that the largest economy in the world (the USA) would have its sovereign debt rating reduced from AAA I would have suggested that you see a psychiatrist, but that is precisely what has just happened, due in no small part to political incompetence shown by the rival Democrat and Republican parties in what is seen by many as the start of the 2012 US presidential election race. In

addition the deal that was struck contains a number of spending cuts which the market fears may push the USA back into recession.

At the same time problems regarding debt levels in the Eurozone for countries such as Greece and other members of the Euro will not go away as politicians basically “kick the can”, ie deal with relatively short-term cash flow issues rather than the underlying structural problem. This was brought to a head when European Commission President Jose Manuel Barroso basically said that the deal that had been struck on 21 July to help Greece had failed to stem the spread of the debt crisis in Europe and in addition said that elements of the

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Statistics: the reverse yield gap and the cult of the equity

The following may interest those of you with a statistical bent:

The prospective yield on the FTSE 100 is currently* approximately 4.4% – that is the net amount that would be received by basic rate taxpayers – you would need to receive 5.5% from a comparable deposit account for the same net return. (Although of course the return from the equity is subject to change while the deposit account is pretty much fixed.) Many blue chip companies are now trading on prospective price-to-earnings ratios of around 10 which on a historical basis may be seen as cheap.

If we look at the equity bond yield ratio (or reverse yield gap) then based on the FTSE All-Share Index equities are yielding more than gilts for only the fourth time since 1965. The yield on the FTSE All-Share is currently approximately 3.8% compared to 2.69% on 10 year gilts. This is a ratio of 1.4. This is significant because the reverse yield gap is one of the basic concepts on which the advantages of equity investment is built.

In simple terms, until the 1960s investors had demanded a higher yield from shares to compensate for the risk compared with gilts. Companies, it was argued, could cut dividends, abolish them or even go out of business: gilts were thus better and warranted a lower return.

However in the 1960s the view established itself that the prospect of rising dividends meant it was worth buying shares on a lower initial yield than gilts that paid fixed returns. It was argued that the potential for dividend growth outweighed the risk and as a result the yields on government securities crossed with shares paying less (hence the term reverse yield). Property yields followed on the basis that rising rents made real estate a better long-term hold than fixed gilt yields. Once pension funds and insurance companies accepted this argument they swapped their fixed-income bonds for shares, thus helping push share prices higher and equity yields even further below gilt returns.

Since the 1960s the reverse yield gap has gone above 1 (indicating that the “old” position of gilts yielding less than equities has appeared again) on a number of occasions, the first being in March 2003, the next in September 2008, then in May last year and now the current appearance. You can view this statistic in a number of ways but for me the basic question is whether you want, for example, to purchase a 10-year gilt yielding approximately 3% with a fixed payout on maturity or a blue chip equity potentially yielding perhaps twice that with, based on the capitalist system, the potential for growth – I know which one I am opting for.

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21 July deal could change. The market also came to the collective realisation that the 21 July deal does nothing to reduce the Greek debt mountain or stimulate economic growth – in effect it just eases the cash-flow problems until 2014 – hence the term “kicking the can”.

I wish that I could tell you when and how these problems will resolve themselves – it may be that despite the incompetence of politicians the USA avoids a “double dip” recession, perhaps by a further dose of quantitative easing, and that the downgrading of its debt does not materially affect the interest rates levied on its sovereign debt. It may also be the case that politicians in Europe “grasp the nettle” and realise that either certain countries have to leave the Euro (which would be painful in the short term but not necessarily catastrophic – remember when the UK left the ERM in 1992?) or greater integration of fiscal as well as monetary policy is required so that a Eurozone Bond can be issued by the whole group to stop individual countries coming under attack from the markets.

Ultimately I am confident that at some point long-term solutions will be found and that although we may continue to experience volatility and indeed further falls in the short-term investors should not panic.

Ask yourself what your aims and objectives are and what your time frame is – are you a “day trader” or are you an investor? Are you a Corporal Jones running around like a headless chicken or are you a Sergeant Wilson? Each individual should, in my opinion, step back and take a deep breath – if you have a financial adviser then you should discuss the position with them before taking any action. Acting in the midst of fear and panic is not the way forward – unless perhaps like Warren Buffett you believe this is an opportunity to buy rather than sell.

Of course I understand that sharp falls in stock markets make investors nervous and uncomfortable – it certainly makes me nervous and uncomfortable when looking at my own investments! However, it is important to retain a sense of perspective - today the FTSE 100 stands at the same level as a year ago. Whilst many individuals buy and sell shares aiming for short-term gains (so-called day traders), most investors look to the long term and are prepared to ride out a storm. This is what I intend to do and indeed I plan to put more money into the market over the coming weeks and months. I will continue to phase money in – I intend, as Mr Buffett so rightly advises, to be greedy while others are fearful.

* This article was written on 7 August 2011

Stay invested or sell?

- Remember that although you may be sitting on hefty paper losses these are only actual losses if you sell, and if you sell then how are you going to recover those losses – or perhaps you are happy to take the losses on the chin and put it down to experience? If that is the case fair enough but please then do not feel hard done by when at some point in the future you look back and say that you wish you had remained invested.
- Ask yourself why you invested in the first place – have the fundamentals changed?
- The fact is that historically when markets have fallen they have recovered, sometimes very rapidly but invariably over a medium- to long-term timeframe (minimum three to five years). Markets can react in market booms by creating bubbles and becoming overvalued and there is no doubt that in times of crisis such as we are currently experiencing markets can overreact on the downside.
- I must stress that there are of course no “guarantees” and I am not saying that markets may not fall further but I would urge you to consider the fact that equity markets are ultimately based on the capitalist system – do you believe in capitalism and the possibility to make profits – if the answer to that is yes then think a little before dumping your investments.

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