McInroy & Wood

PERSONAL INVESTMENT MANAGERS

"You find not the apostrophes and so miss the accent: let me supervise the canzonet. Here are only numbers ratified."

L.L.Lost

Perhaps the most stimulating debate to emerge from the scientific revolution of the past 60 years or so has been about the respective contributions of the arts and science to the advance of knowledge. Get going on this subject and passions quickly run high. Protagonists become polarised into opposing camps, never more so than in the celebrated spat in the 1950s between C.P. Snow, the technocratic novelist, and F.R. Leavis, a Cambridge literary critic. More enlightened debaters like Lord Broers, this year's Reith lecturer, acknowledge the vital contribution of both science and the arts. "We need those with understanding of history and the arts to enable technology to be used for good."

For all the passion of the polemicists, the issue boils down to the simple truth that some of us are happier to talk about our world in terms of hard evidence, objective criteria, incontrovertible proof; others prefer to describe it in terms of ideas, of behaviour, of emotion, of perception. Each group may often be describing complementary facets of the same truth, one gaining lustre from light shed by the other. We learn from both.

Investment analysts can be grouped either side of a similar mental divide. One group prefers to examine static factors, economic statistics, financial ratios, numerical criteria and draw from them clear-cut market conclusions. Once they establish a trend line, they are free to extend it into timeless investment prosperity or alternatively into a financial Armageddon. Their skill is to resolve the infinite shades and nuances that colour market movements into a black and white picture. They are the still photographers of the investment world.

The other group concentrates on dynamic factors – the habits and proclivities of savers and spenders; they assess the motive power of mass endeavour and human appetite to enhance or restrict the wealth creation process. They are movie makers and for them, businessmen, politicians, the man in the street provide the story line, economic statistics the mere detail.

Each method has its limitations. The photographers are stuck with a picture frozen in time and so they tend to get stuck with their conclusions too. Dr Henry Kaufman was Wall Street's photographer-in-chief of the 1970s. Through the years, decades even, he stuck unswervingly to an apocalyptic forecast for American capital markets oblivious, it seemed, of the passage of time and circumstance. Eventually, of course, he was proved half right – as are we all if we stick to forecasting rain sometime.

The danger for investment movie makers, on the other hand, is that they lose touch with reality. They may anticipate some of the ebbs and flows of investor sentiment but, without a primary focus on the visible evidence, may fail to spot a Tsunami of economic mishap or a flood tide of prosperity just about to roll in.

Analytical styles are more blurred at the edges than these stereotypes suggest, but they do at least explain why market pundits often persist with patently silly viewpoints when they get stuck on an idée fixe, while others derive satisfactory investment conclusions and a celebrity reputation from apparently idiosyncratic assumptions until they, too, are swamped by an obvious development they had overlooked. Two investment methods, each on its own inadequate.

Science offers a parallel of sorts. Since Dirac's work in 1928, physicists have used two entirely different expressions to describe a ray of light. They refer to it at one moment as a wave, at another as a bunch of energized particles, depending on the time and context of the analysis. Analysing the financial world is like analysing the micro world; you need to keep mental hold of two different constructs to get an adequate view of what is happening at different stages. It isn't easy.

Looking back to the last turning point for the UK equity index in spring 2003, it was possible to peer through the gloom of the snapshot verdicts and judge that prices were far more likely to move up than down given the efforts of

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governments, central bankers and regulators to stimulate flagging markets. The dynamic factors were pointing up. And so it has proved.

Two years on, market views have converged on a dull consensus that, while bond and stock prices are both quite high, profits and dividend increases in 2005 should be sufficient to sustain some upward momentum, at least for equity markets. Indeed, that is our own view though it is much more guarded about prospects in the UK than overseas.

In reaching it we have shifted focus from the dynamic factors that marked a turning point to the static ones that underlie a normal business cycle and the market trend that goes with it. But how long is a trend? Little by little, the cycle ages, national productivity falters, and company efficiencies become more difficult to achieve. Perhaps that is the point we are approaching. Maybe we are entering a natural pause in a longer upswing, but maybe we are near another turning point.

In trying to assess the future course of global markets, three possible outcomes suggest themselves. First, the upswing could be sustained for several more years by the unwinding of the natural economic cycle in which the complementary forces of government spending, personal consumption and business investment reinforce the trend at different stages of a benign growth path.

Or, the recent recovery could be simply the product of monetary stimulus, introduced in the USA and UK as a knee-jerk response to the last slowdown post 9/11. Rock bottom interest rates encouraged people to over-borrow and overspend and now that interest rates are rising again, consumers may simply have insufficient disposable income to keep the upswing going.

In the first case the ultimate change of direction will be far enough away to be largely irrelevant for financial markets; periodic investment snapshots should reassure investors about the strength of the upswing as it gets going. In the second case, any setback would likely be modest and, while unwelcome for those who over-borrowed – would do little more than arrest the markets' progress for a few months while consumers retrenched a bit and profits caught up with expectations. Investors might feel a draught but not a gale.

There remains the third possible outcome. This rests hardly at all on statistical calculation of spending or profit trends – not in the first place anyway – but on assessing the staying power of the enterprise culture itself.

We simply wonder for how long constituents of what is now a global free enterprise system will acquiesce in it when the results of that system must seem increasingly questionable to many. When on the global stage its current workings are displayed, for example, by British and American policy in the Middle East, by American energy and environmental policy, by European agricultural policy; and here at home by corporate journeymen shovelling – or rather fork-lifting – shareholders' money into their pay chests with no commercial justification; by a 'developed' society where the gulf between the richest and the poorest groups grows ever wider; by a Western democracy which claims to cherish human rights yet can only secure them by imprisoning more of its citizens each year.

Perhaps the hundreds of millions now actively engaged in the global capitalist experiment will be enough to ensure that private business and personal profit remain a central concern of most administrations. After all on May 5th British electors were offered and voted for a third term of conservative, market-based muddle-on-the-road management by an ostensibly socialist government.

But the present climate in the UK and across the globe should not be taken for granted and if the tide turned against the enterprise revolution of the past quarter century, as in Britain and continental Europe it could easily do, the implications for investors would be large. A counter-capitalist reformation would be an epic drama and well worth the film-makers' attention. While the current investment snapshots still show a fair enough prospect, we are keeping a movie camera at the ready in case the investment photographs begin to blur and the images they represent no longer square with the reality as it unwinds.

23rd May 2005

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