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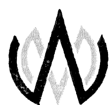
Independent Investment Consultants



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. . . How poor are they that have not patience!

— (Othello)

This commentary is the first of an occasional series which we intend to write about our market views and related topics. Only when our views change or when a subject deserves special comment will we go into fresh print. Without a routine production schedule to weary reader and writer alike the series will, we hope, gain something in interest and vitality.

Bear markets do not occur in response to single events. President Kennedy's assassination sent the Dow Jones average down for only a day or two. Really big falls (and rises) occur when critical forces build up pressure for change and eventually reverse the tide of investors' sentiment. Stock market prices merely measure people's behaviour, and habits of behaviour do not as a rule change quickly. In a word, if you expect a market to turn up or down you must be prepared to wait a while for this to happen. Impatience can be a deadly enemy of the successful investor.

Here we are with the U.K. market now in the 13th year of a rise that began in 1974. Few investors in Britain have experienced a stronger bull market; many indeed have never seen a bear market. The rise has gone on for so long that in a sense it has trapped investment managers worldwide. If they are out of a market rising like this one they fall behind in the performance race. Results in this race are measured over months, and many of those running have only themselves to blame if they are timed for a sprint when in reality they are running a marathon. Advertisements, promotional literature, and what the regulators now call "hortatory" circulars all too often parade a performance "track record" measured over short and highly selective periods. In this fever of activity, few managers can afford to sit out for six months. Instead, liquidity round the world is being sucked into equity markets because the return from stocks has been so good; and as long as the new money coming in is weighty enough, markets go on rising. But eventually value tells. Equity yields fall too low, new equity offerings overwhelm the market, earnings and dividend growth is diluted and disillusion sets in. Liquidity which has flowed into stocks then flows out again and the tide of sentiment turns. Is it about to happen?

Political and economic trends in the U.K. are remarkably favourable and well rehearsed. Things are going well, and the market knows it. The many negative factors worldwide are perceived but then, as happens near the end of bull markets, are shrugged off. At a time like this it is worth reflecting for a moment on what we are expecting from our equity investments. Consider what happens to £100 invested equally in equities yielding 3.4% and gilts yielding 9.0%. If one assumes that dividends grow at 10% p.a. and all dividends and interest are reinvested at the starting yield, it will be about a quarter of a century before the equity yield reaches the gilt yield. This is hardly a balance that favours the equity investor at a time when inflation is more likely to fall than rise. In the 1950's chronic inflation was unforeseen and consols yielded on average 4.3%, while equities were seen as risk investments requiring a yield premium of about 1% over gilts. Twenty-five years later inflation was the overwhelming factor which dominated investors' thoughts. Inflation in Britain peaked in 1980, but investors are still carrying its scars today and are requiring heavy protection against it even though that battle has, for the moment anyway, been won. The position now is exactly the reverse of that in the 1950's. What is unimagined today is a generation of price stability. Gilts are the perceived risk investment and equities are priced as if they were relatively risk-free.

Yield relationships are not of course set immutably and the lessons of history, though instructive, are not infallible. Yet sentiment will always run in cycles and it is tempting to think that in this one it will be neatly reversed. Even as U.K. equity prices fall, as surely they will, one might expect fixed interest investors to enjoy the bull market of a lifetime. It may happen like that, but it is more likely that the trauma caused by falling equity prices will, in the short term, shatter confidence and all security yields may rise. With this prospect in view we recommend that equity portfolios be significantly reduced; that only part of the sale proceeds be invested in government stocks, and that part should go to build up cash reserves. Our own model portfolio has only a 40% equity content. Private investors can raise their liquidity levels far and fast and this gives them a real and perhaps forgotten advantage over the investing institutions. Here is an opportunity to use it. Patience will bring its reward !

May, 1987.

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