

A Collapse of Confidence

The events which have unfolded during the last few weeks have been truly shocking.

It wasn't long ago that we thought the banking crisis was almost over, and that it was unlikely another bank would get into difficulty. That was before Lehmans, HBOS and the collapse of Icelandic banks.

Our recommendation to rebalance equities at 5,600 now seems wildly optimistic and with warnings from the IMF and a complete collapse in confidence it is difficult to know how far markets will fall before recovering.

The actions taken by the powers that be over the weekend may go some way to bringing calm back to markets, and this morning we have seen a 5% upward movement in the FTSE 100 (correct at 8.30 am). Whether this is the beginning of the end or just another bear market rally remains to be seen.

We still believe that equities are attractive on a 5 year view. This is not wishful thinking, but based on historically accurate measures such as price/earnings (P/E) ratios, dividend yields, and dividend cover.

P/E ratios, which have historically averaged 14 to 15 on the UK market, are currently 8.2 (source: FT.com). This means earnings would have to fall by almost half before the ratio reached the historical average at current prices.

Dividend yields are now significantly above the yield on Gilts. This is another measure which has historically been a "buy" signal.



The Human Touch

Of course, these fundamental measures ignore the human element of investing, and markets are founded on confidence. However, another indicator is the Director's dealing ratio which is at a buy to sell ratio of 25 to 1. This is compared to a long term average of 2.5 to 1. Simply put, Directors are buying ten times more shares in their own companies than normal.

Anthony Bolton, arguably the best fund manager in UK history said recently that:

"I have bought shares in the last couple of weeks for the first time for some time. I see a lot of value in certain areas of the market."

"I have been somebody who for quite a while has been cautious about the equity markets. In fact I started my caution about two years ago - I was a bit early."

"I have to say the events of the last few weeks for the first time have made me feel more optimistic that we are getting near the low in the markets."

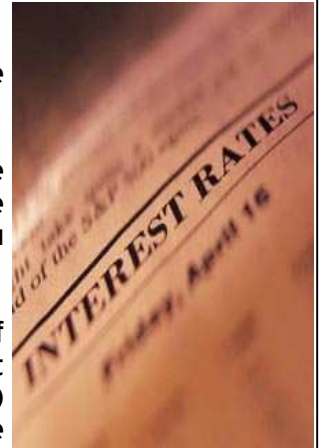
Fixed Interest

Whilst we have naturally been focused on the equity market, the Corporate Bond market has also suffered.

However, in times like these we look for small comforts, and the change we made to our Fixed Interest portfolio has made up to an 11% positive difference since the start of the year. This depends on which version of the portfolio you hold and when your individual investments were switched.

The government action should hopefully have a positive effect on bonds. If you held a bond in RBS or HBOS (in which the government is now a significant shareholder), then last week this would have been yielding (paying interest) around 10% per annum. If you believe the government would not let these banks fail then this looks an excellent risk adjusted return.

We hope to see at least some recovery in bond markets once various global bail out packages are finalised. This should be helped by the recent drop in Bank of England base rate, with further cuts anticipated.



Strategy

If you had 35% in equities at the start of last week then after the 20% drop it is likely your portfolio will now have around 28% in equities.

Our strategy is always to buy on the way down and sell on the way up. It is impossible to accurately call the bottom of the market but if we follow this strategy we will gain in the long term.

It is our recommendation that you re-balance your portfolio back to the ideal level of equities. If you would like to consider this then please contact us and we will make individual recommendations, or you can discuss it at your new review.

Applewood and You

I have always said in meetings with clients that our interests are completely aligned with yours.

In some ways your money is our money, and if your investments go down then so too do our fees. Therefore, every decision we make is made with great care.

It is in our interests to maximise your returns, but also not to take undue risk. Our recommendation to top up equities is made with both these concerns in mind and we believe it is in the long term interests of both you and Applewood.

Colin Lawson CertPFS
Managing Partner

13 October 2008 at 8.30 am

To discuss how best to take advantage of current market conditions, please contact your usual adviser.