

## Double Think

There is a very fine line between sitting on the fence and double think.

Double think was defined by George Orwell in 1984 as holding two completely contradictory beliefs and believing both to be true.

Unfortunately, we often suffer from double think and for very good reason.

### A Crossroads

I have recently been passed two reports by the same client which provide professional opinion as to the likely market performance over the next 12 months or so.

The first is incredibly bullish and is predicting very strong returns from almost all markets, but especially equities.

However, this source (Fisher Wealth Management) is renowned for always having a positive outlook. I do recall they once said that the subprime crisis wouldn't affect equity markets at all.

The second is John Mauldin's Reality Check e-letter which argues the opposite. It highlights that bank losses will accelerate significantly and that as a result the equity markets are likely to lose 20% or more which would see the FTSE 100 falling to the lows of 2003 in the region of 3,300.

We therefore have two contradictory views. One that the market could rise 20% over the next 12 months and one that it could fall by 20%.

They both make compelling cases as to the reasons why. They are, of course, both correct in that if the series of events unravel as they have outlined them then the markets will, indeed, react as they envisage.

### So What Do You Do?

Both reports do believe that at some point the market will, indeed, recover significantly. This means there are clearly three choices.

#### Quit the Market

You could, of course, quit the market entirely and hold money in cash, guaranteeing almost a zero return. Then wait until the bearish predictions become true, buy into the markets at all time lows and secure yourself very high gains once the market starts to recover.

This would be the ideal strategy if you knew exactly the right time to buy in. Unfortunately, no one can know, and so this strategy is very high risk.

#### Go All In

You could decide that the upside is significant enough to invest all of your assets into equities at the current market levels. We suggest that this would be foolish.

#### Maintain a Balanced Portfolio

We believe that this is the most sensible option, perhaps being slightly overweight in equities compared to where you would be if the markets were at relative highs. If you have a three year view then what happens over the next three weeks or even months is irrelevant. Taking a three year view, we strongly believe this strategy is the least risky.



## Long Term Profit Despite Short Term Volatility

The risk of missing the upside by being out of the market is much greater than suffering the down turn.

If you miss the upside you can never get that money back. There is no second chance, no reprieve. If however you suffer the downside it is likely to bounce back much quicker and much stronger.

Let's take the example of the 1970s where the market fell 33% in the 1973, and 51% in 1974. It then rebounded 145% in 1975. As the table below shows, an investor who invested 100% in equity would still have made money after five years. However, if you had a more balanced approach and constantly rebalanced your portfolio throughout this whole time period, you would have made a significant profit on the deal.

*Two investors each invests £100,000 at the start of 1973. Jack invests 100% into equity. Mary invests 50% in equity and 50% in cash. Crucially, she also rebalances annually back to 50/50, banking gains and being bold, buying in at market lows. Even after falls of 33% and 51% she remains confident that markets will recover and, despite the short term risk and the overwhelming negativity, she sticks to her strategy.*

Year	Equity Return %	Cash Return %	Jack's Portfolio Value at End of Year (£)	Mary's Portfolio Value at End of Year (£)
1973	-33	7	£67,000	£86,500
1974	-51	8	£33,000	£67,500
1975	145	7	£80,000	£119,000
1976	-4	7	£77,500	£121,000
1977	54	7	£119,500	£158,500

Portfolio	Total Return After 5 Years	Maximum Loss During Period
Jack's 100% equity portfolio	19.5%	67%
Mary's balanced portfolio	58.5%	32%

## Cash Conundrum

I am pleased to say that before the latest round of interest rate cuts I placed some money in an account with a fixed rate of 6.15% for 12 months. That means that I have got ten months left to go before my return plummets to probably zero. I was amazed to find out from a client that I can now top up this account to any amount up to £9,000,000!

I think this is what the hedge fund industry calls an arbitrage opportunity. For those of you who are getting very low interest on your deposit accounts you could lend me the money. I could pay you 5.15% interest and pocket the 1% difference.

As usual, there are a couple of hitches. I would be a higher rate taxpayer whereas you might be a basic or a nil rate taxpayer and you, of course, run the risk that I could do a "Madoff" and make off with your money. The account is legally only available for my personal money and not as an "institutional investment."

**Apart from those minor issues it does appear to be a cunning plan!**

I am, of course, joking but there is a serious point here. With interest rates so low, the returns on your cash are likely to be minimal. We believe many clients could afford to invest part of their cash in our lowest risk fixed interest fund, which has returned a steady 5% to 6% per annum over the last couple of years. Of course this would be increasing risk, and past performance is no guide to the future, but where you have the tolerance we feel this would be a sensible course of action.

Please contact your adviser if you wish to discuss this further.

**Colin Lawson Cert PFS, Managing Partner**