

## Introducing....

Welcome to the first in a regular series of updates issued by the Applewood Investment Team.

You may well have received briefing notes from our Managing Partner, Colin Lawson in the past. Colin will continue to issue these as and when something of interest occurs. In addition to these, our Investment Team will issue their thoughts on a more regular basis.

## Buy Now While Drops Last

August was another volatile month in the equity markets, with the FTSE dropping to 5,350 before rising to around 5,600 at the end of August and back down to 5,300 again in early September.

What is becoming apparent is just how attractive equity markets look based on **FUNDAMENTALS**. That needs to be in capitals, because it doesn't mean they cannot drop sharply due to sentiment.

UK equity markets are trading at a price/earnings ratio of around 10 times earnings, which is the lowest they have been for 20 years. The long term average is around 14 times. Even if earnings drop substantially there appears plenty of scope for growth.

The other attractive fundamental is yield. One of our preferred funds is the Schroders Income Maximiser fund which targets an ongoing yield of 7% per annum. Normally, they achieve around 4% to 5% of this income from dividends of the underlying shares and the rest from a clever but slightly complicated strategy of selling options.

For the upcoming period, Schroders have decided not to bother selling options as they have already achieved their target yield for 2008. Again, this shows that equities look historically cheap, and we believe that buying at a FTSE 100 level of 5,600 or below would represent excellent value over the long term.

Of course past performance is not a guide to future returns. That isn't just a caveat, it's actually true. The main reason for the cheap looking markets is because traders are still nervous about further shocks to the system. What gives us hope is that markets look so cheap that plenty of further bad news ought to be able to be absorbed and equities could still look good value.

## Political Risk

If anyone was still wondering why we differentiate between the established and emerging (speculative) markets with our equity portfolios, you only need to have turned on the news during August to find out.

The areas we define as established not only have established markets, but also established democratic regimes. These areas are Western Europe, North American, and Japan. The established areas are politically very stable (invasions of oil-laden middle eastern countries aside), and in terms of stockmarkets it probably doesn't make that much difference if governments are Tory or Labour, Republican or Democrat. These areas have very different risks to most of the emerging markets.

If you had invested in Russia over the past few years you would be sitting on a hefty profit right now. Unfortunately, the problem with countries like Russia is their government can do unpredictable things, such as sending troops into a neighbouring country.

(Incidentally, is it just me that thought South Ossetia was an area from the Shipping Forecast?)



Regardless of the rights or wrongs, this type of action can have a destabilising effect on markets, and Russian equities have been extremely volatile since the news broke. They had already fallen by 20% since May and fell 10% in two days on the back of military action.

I was interested to read the following comment from Elena Shaftan, manager of the Jupiter Emerging European Opportunities fund and herself a Russian: "We don't suggest that Russia is a fine example of democracy or an easy environment to do business in - one needs to tread carefully, watch the market closely and know the terrain."

Ms Shaftan went on to list all the various Russian issues over the past ten years:

'We had Chechnya, default and devaluation in 1998, the apartment bombing in 1999, a number of terrorist attacks that have been badly handled by the authorities, the Litvinenko case and the anti-missile defence spat with the US, tensions with Estonia, BP-TNK and, of course, Yukos.'



Many clients would not be able to stomach this kind of turmoil, whatever the potential rewards (and those rewards have been great). Despite all these issues, Russian markets have returned 1,700% (according to Jupiter) in those ten years.

I'm sure you will agree, this is a fine example of the relationship between **risk and reward!**

### \* A Minsky Moment

Hyman Minsky was a professor of economics at Washington State University. The theory named in his honour states that stability breeds instability. The longer something is stable, the more instability there is when the moment of instability happens. Stability creates an environment where people feel safer taking on more risk and leverage (borrowing). Then when things do go wrong, they go very very wrong.

Property is a great example of this. It has suffered from what is known as a "Minsky moment". It went up steadily for a number of years, people borrowed as much as they could to invest, ignored the risks and the fundamentals (such as your rental income should exceed your loan repayments!). Property has now fallen sharply, commercial property leading the way, with one property fund falling by 20% almost overnight. House prices are down too, falling over 10% in the last year and we predict total falls of around 30% before the recovery begins.

We like to call this "too good to be true risk". If we see an investment with very steady, non-volatile growth, we tend to get a little nervous. There is probably some other risk not reflected in the numbers. Often it is liquidity risk (as with property) - the risk that you can't sell assets when you need the money.

People often confuse volatility and risk. Volatility is merely one form of risk. If there is little volatility then there is often little liquidity, or the possibility of sudden, unexpected price movements. The risk is still there, it is just hidden.

**Mike Deverell**  
Investment Manager

*Did you enjoy this update? Do you have any comments, queries, or suggestions? We would be pleased to hear from you.*

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