

Investment Newsletter

January 2012

equilibrium
asset management

Happy New Year!

Most investors will probably be glad to see the back of 2011.

A year which began promisingly enough descended into turmoil as European nations struggled with their debts, and politicians blundered from one failed rescue plan to another.

2011 became the year when "political risk" in investing, normally something associated with emerging economies, came to the fore in the developed world.

It is extremely difficult to try to predict what politicians might do. Modern Portfolio Theory makes the assumption that investors tend to act rationally, at least in the long term. However, when markets are driven by political decisions which are made without any economic rationale, motivated by the need to placate angry voters, then short term market movements become even less predictable than usual!

Given that we cannot predict what politicians will do, we have to go back to basics and focus purely on valuation. Our process is to make a decision about what we think an asset is worth and compare this to the current market price. We can then make some reasonable assumptions about what this might mean for that asset class in the long term.

Finally, we then carry out some "what if?" analysis to try to work out what might happen in different scenarios.



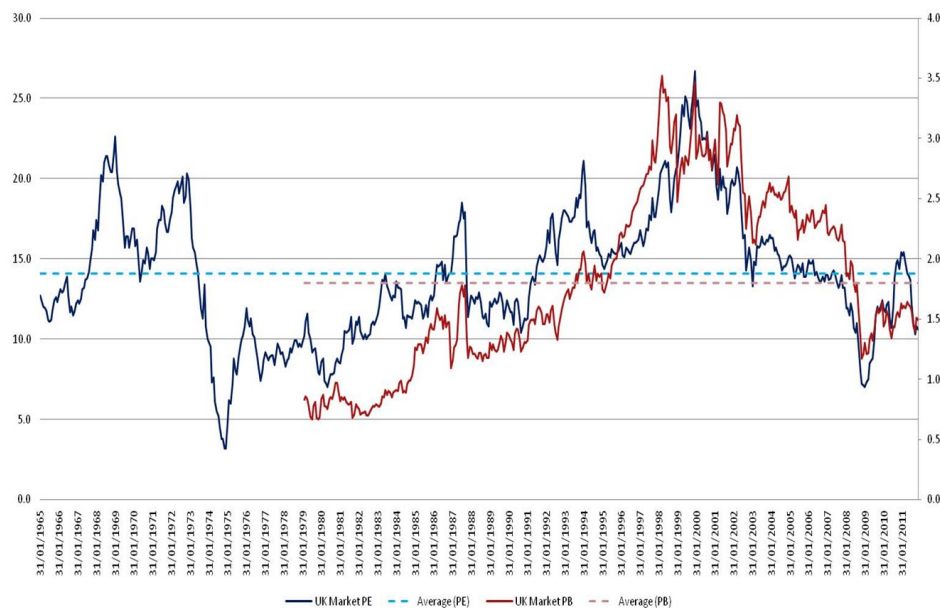
Valuations

We often talk about Price/Earnings (P/E) ratios as a primary way of determining whether or not equity markets look good value. This simple ratio takes the current price of a stock and divides it by its earnings per share. This is then used to calculate the market average.

Research shows that buying equities when P/E ratios are low generally leads to much greater long term returns than buying when P/E ratios are high. To put it another way, buying when the market is cheap gives better returns than when the market is expensive!

This may seem like stating the obvious, but it's amazing how often such simple principles are ignored when investors start listening to all the market "noise" and speculation. That's when rational analysis tends to lose out to emotions like fear and greed.

The chart below shows the UK equity market P/E ratio (blue line) since 1965. The dotted blue line shows the average P/E ratio over this period. At the date of this chart (end November 2011) the UK market P/E was 10.6 compared to the long term average of 14.1:



Equilibrium analysis using data from Thomson Datastream

Research shows that markets tend to be mean-reverting in the long run. The current P/E ratio would have to rise by more than 30% to revert to the long term average. If company earnings do not change, this means the market needs to rise 30% to revert to the average P/E.

The red line in the chart shows the Price/Book ratio of the market and the dotted red line shows the average Price/Book ratio. This ratio is the current price of the market divided by the average "book value" of the companies; the value we can derive from their accounts. The ratio is currently 1.5, meaning it would need to rise by 20% to revert to the long term average of 1.8. On both measures, in our opinion the market looks "cheap" compared to historic averages.

At the time of this chart, the FTSE 100 was at around 5,500. If we just work on the P/E ratios then we believe the true value of the FTSE based on earnings ought to be above 7,000.

Of course, we are in difficult economic times and so we need to do some analysis to show what value we think the FTSE could be if earnings fall.

If earnings per share fell by 10% then, in our view, fair value for the market is somewhere around 6,500.

If earnings per share were to fall by 20%, then we think fair value is probably somewhere around 5,800. We are clearly in a low growth environment and recession is certainly possible. Research has shown that in previous recessionary cycles, earnings tend to fall by perhaps 15% to 20%. Therefore, even if we see recession we believe the market could still be undervalued.

It is worth remembering that a large proportion of the earnings of UK listed companies come from overseas. Recent economic data from the US has been encouraging and a global recession seems to us to be unlikely. In our opinion, earnings could therefore hold up relatively well.

We hope this gives you a flavour of the sort of approach we take to investing. We have a similar approach to the other asset classes, and this is how we come up with the scores shown on the last page of this document.

The above example shows why we remain positive on equities. Having seen a decent rally we are less positive than we were, but despite the likelihood of more volatility, we would expect to see some reasonable growth over 18 months.

It is impossible to predict future events or how people react to them and we don't try to do so. However by purely focusing on the facts, buying assets when they appear cheap and selling when they appear expensive, sooner or later we believe we will be rewarded.



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General Economic Overview

Global economic growth is likely to remain muted. We believe global recession will be avoided, partly due to an improving US picture in terms of jobs, growth and consumer borrowing. However, recession is very likely in the Eurozone. Interest rates are likely to remain low for the next 18 months at least.

European sovereign debt issues will continue to concern markets for some time causing occasional bouts of volatility. Inflation may fall back in the short term but we remain worried about it in the long term.

Asset class key

+	positive	+5	strongly positive
-	negative	-5	strongly negative
=	neutral (normal behaviour)		

Equity Markets	Outlook
We remain positive about equity markets despite the recent rally. Earnings have held up well and markets look undervalued on a Price/Earnings basis. Dividend yields look attractive and companies still hold high cash levels, which means dividends appear well covered.	+1
Fixed Interest Government have rallied due to risk aversion in other asset classes, whilst high yield and bank bonds have fallen back. We expect below average returns from fixed interest in general, but some pockets of riskier debt look great value after market overreaction to the current crisis. In addition, inflation and interest rate risk has receded for the short term.	-2
Commercial Property Whilst the rental yield on commercial property remains attractive at over 6%, this is diluted by high levels of cash in property funds. Capital growth is dependent on economic growth which is likely to be poor.	-4
Residential Property We believe prices are likely to remain flat over 18 months.	-5
Cash With interest rates remaining at record lows, returns on cash could remain below average for some time. However, there is a short term safe haven appeal.	-5

Balanced Asset Allocation

For a typical balanced portfolio we are overweight equity and cash and underweight the other asset classes. Based on our above scores and current tactical positions we'd expect a Balanced Asset Allocation (excluding client cash) to return approximately 8.1% pa rather than the normal 8%pa.*

A neutral score (=) means we expect the asset class to move in line with our long term assumptions: 10% pa for equity, 7% for property, 6% for fixed interest, 5% for residential property, and 3% for cash. A +5 score means we think the asset class could outperform by 50% or more. A -5% means we think it could underperform by 50%. A negative score does not necessarily mean we think the asset class will fall.

* Includes Defined Returns holdings. See previous briefings for details.

These represent Equilibrium's collective views. There are no guarantees. We usually recommend holding at least some funds in all asset classes at all times and adjust weightings to reflect the above views. These are not personal recommendations so please do not take action without speaking to your adviser.