

## Overview

If you have been tracking our asset class views recently you will see we have been positive on equity for a while.

Our last two briefings have explained why we are currently negative on fixed interest. The main reasons are that inflation remains stubbornly high, and interest rates may rise as a result. We are expecting slow but positive economic growth in the UK.

So, assuming we're right about this scenario, how would this affect equity markets?

In theory, equity can do well in an inflationary environment.

If prices rise, companies are increasing their turnover. Their costs will increase too, so the type of company you buy is important.

Generally, this environment is great for large companies who have buying power. Take the example of the big supermarkets, notorious for squeezing their suppliers into submission. Even in an inflationary environment, you can be sure the prices they pay won't rise as fast as they will for the rest of us!

Rising interest rates add to a company's borrowing costs. Companies with high levels of borrowing will suffer, whereas those with high cash levels could prosper. There are many companies in the UK who cut costs quickly during the credit crisis and emerged much stronger, holding more cash than they need to run their business.

Companies could use that additional cash to boost dividends, or to look for merger or acquisition opportunities. Both of these are good for share prices.



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## Equity Valuations

There is a big difference between the price of a share, and the value of a share. A share price can be at its highest ever recorded price and still be undervalued. Likewise, just because a share is cheap compared to its price history, it doesn't mean that it's good value!

One simple way of looking at where a share is good value is to consider its price/earnings (PE) ratio. This is simply the share price divided by the company's earnings per share, both of which can be easily obtained. The lower the number you get the potentially better value the stock (but you do need to be careful – see below).

Looking at the UK market as a whole, its long term run average PE ratio is around 14, meaning the price of the index is 14 times its earnings on average. At present, the UK market is trading on a PE of around 15 times HISTORIC earnings\*. On this basis, it looks to be relatively fairly valued.

However, markets are forward looking and consider not just what has already happened, but what is going to happen. Most analysts are forecasting an increase in earnings this year, and depending on who you listen to, the PE ratio on the FTSE 100 Index could be around 10 to 12 times. If so, the market looks decent value. The big caveat is that it is based on their ESTIMATES for future earnings, which could be completely wrong!

We believe that there are definitely reasons to be positive about equities. In particular, we are positive on equity income type funds, such as those within our UK Large Companies portfolio. The sort of companies being bought by our funds generally fit the criteria outlined above, having high cash levels and pricing power.

When looking at the PE of an individual stock, you need to be careful because a low PE might be because there is something worrying investors which has caused the share price to plummet. It is only ever an indicator and just one factor that we and the fund managers consider.

Many of the equity income type stocks are on relatively low PE ratios and so look good value relative to the market. The current PE ratios of the top 5 stocks held by our funds are shown below:

Stock	% of Portfolio	PE Ratio**
Vodafone	5.81	8.39
Astra Zeneca	5.88	8.63
Glaxo Smithkline	5.74	11.51
Royal Dutch Shell	3.35	10.32
BP	2.64	4.14
<b>Average PE Ratio</b>		<b>8.5</b>

Many of these stocks were somewhat left behind in the rally since March 2009. As we have said before, it is generally the worst companies that have done the best in the past couple of years, as these are the ones which fell the most in the financial crisis. The good quality companies have been left trailing, but we don't think this can last.

\* Source FT.com

\*\* Source: All figures historic PE according to Google Finance 14/2/11 except BP. BP is projected forward, PE taken from Yahoo Finance 14/2/11

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I recently wrote an article for Citywire about how to position your portfolio for an inflationary environment, which covers much of what I've said above but also looks at how inflation affects the other asset classes. The article can be found at:

<http://citywire.co.uk/money/where-to-invest-as-inflation-rises/a465462>

(registration may be required).

## Emerging Markets

Having said we are positive about equity in the UK, we are slightly worried about emerging markets.

The inflation problem in emerging markets is much higher than in Britain. Much of the money created by quantitative easing in the West has found its way into emerging markets and commodity prices. This means that China and the like may raise interest rates quite steeply and may even introduce capital controls to stop so much money flowing into their economy from the West.

Emerging market equities have continued to rise steeply until recently, and there is concern that markets have gotten ahead of themselves. We have already seen quite sharp falls at a time when markets around the rest of the world have grown, and we are concerned this could continue.

We are switching some of our global emerging market exposure to a global equity income fund instead. This invests in similar companies to the UK funds mentioned above, but on a more global basis.

We are switching both the JP Morgan Emerging Markets fund and the Allianz RCM BRIC Stars fund to the Invesco Perpetual Global Equity Income fund. This is run in the same way to Invesco's highly regarded UK Income fund run by Neil Woodford.

This change reduces emerging market exposure for most clients by around 60%. As always, we would much rather reduce the chance of losses and accept that we might miss out on some growth, than take more risk than we think is justified by the potential returns.

We will monitor the situation with a view to switching back when we think the time is right. For example, if we see further falls in emerging markets we may try and buy back in at a lower price.



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# Market Views | February 2011

## General Economic Overview

GDP growth is expected to remain muted but will recover from last quarter's negative result. Inflation may remain well above the Bank of England target for some time, and potentially could be a concern in the long term.

Interest rates will have to rise this year but will remain relatively low to try and stimulate economic growth. Raising interest rates would have little impact on inflation, which is mainly being driven by commodity prices and the VAT rise.

If our scores below turned out to be correct, our balanced asset allocation could return around 7.1% over the next 18 months compared to our long term assumption of 7.6% pa.

### Asset class key

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

Equity Markets	Outlook
<p>Despite recent upward moves, equities still look fair value on current earnings. Earnings continue to be revised upwards and if projections are correct there is the potential for further growth. We remain overweight "alternative equity" giving exposure to further equity growth but with some downside protection.</p> <p>We believe that high quality, well capitalised companies should outperform, as they have not seen the same growth as poorer quality stocks.</p>	+1
<p><b>Fixed Interest</b></p> <p>We are concerned about the risks of investing in pure fixed interest. Given our views on inflation and interest rates, returns on fixed rate bonds are likely to be much lower than they have been of late whilst the risk of losses is increased.</p> <p>However, we believe there is value in inflation linked, variable interest rate, and some high yield bonds.</p>	-4
<p><b>Commercial Property</b></p> <p>The rental yield on the commercial property index remains very attractive relative to other asset classes. However, we are expecting little capital movement and possibly some small capital losses over 18 months.</p> <p>Property funds are gradually reducing their high cash levels, which has been a drag on returns. This should improve total returns.</p>	-2
<p><b>Residential Property</b></p> <p>We believe prices could fall or remain flat over 18 months, well below our 5% pa average assumption.</p>	-5
<p><b>Cash</b></p> <p>With interest rates remaining at record lows, returns on cash are as low as they have ever been. Rates will remain below average for some time.</p>	-5

These represent Equilibrium's collective views. There are no guarantees, although we hope to be right more often than wrong. 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.