

## Negative Equities

We often come across clients who hold direct shares rather than funds. Sometimes this is because the clients enjoy managing the shares, but often the portfolios are not monitored.

Where this is the case the shares are often held for two reasons.

Firstly, for emotional reasons, such as the holder used to work for the company or inherited the shares.

The second reason people continue to hold direct shares is they will have to pay tax on gains if they sell.

To us, capital gains tax is a success tax. We can manage CGT to keep it to a minimum, but we won't hesitate to pay it if the alternative is to put your portfolio at risk. We do not recommend trying to avoid capital gains tax by waiting until your shares have made a loss before selling!

## Doing your homework

Even if you do actively monitor your portfolio there are a number of arguments for not holding direct shares.

A big issue (and a reason we employ fund managers to select our investments) is that carrying out due diligence on direct investments is not easy. Company accounts are complex and accounting standards vary from company to company. Unless you're a real expert, doing your homework is very difficult and time consuming.

In addition to the balance sheet you'll need to look at the company's management, market position, cash generation and long term track record.

## The price isn't right

Having considered all these factors and once you are happy that you have identified a good prospect, you need to make sure you are buying at the right price.

Investing has become so formidably competitive even the smallest of the top 50 US institutions employing active managers spend \$100m a year ensuring they get the first call with new information to the market.

Due to this level of competition it is virtually impossible for a private individual to outperform the market, as any pertinent information will

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be reflected in the price of a share as soon as it is available. This makes identifying mispriced shares extremely difficult and only possible for the most skilful with access to the best information.

## A risky business

One way of assessing the risk associated with an investment is by looking at its short term volatility.

By increasing the number of investments you hold you can lower the volatility and therefore decrease the risk of a big loss.

Take for example a portfolio consisting of 2 shares. If one of the companies folds the investor loses 50% of their investment.

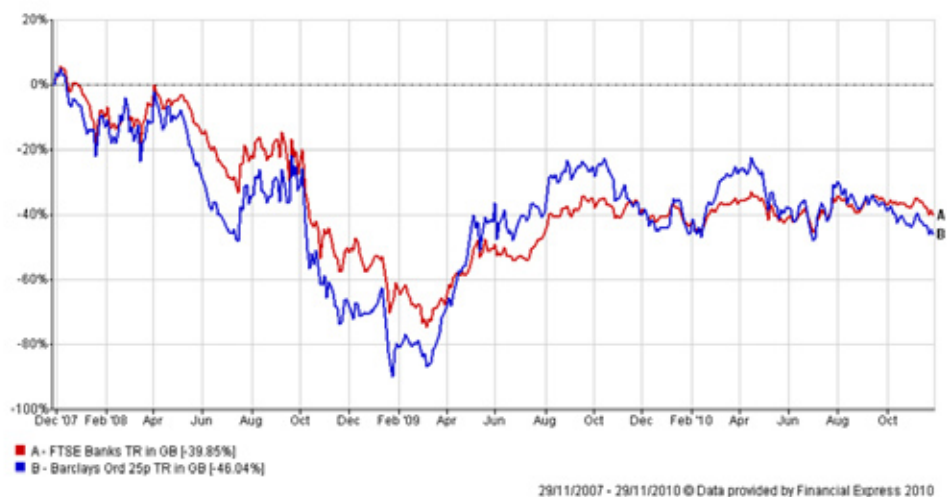
If the investor had held 10 shares and one of these had folded they would only have lost 10% of their investment.

## Volatility

Obviously a company folding is the worst case scenario, but this theory holds true when looking at share price movement.

It is generally accepted that 15 is the minimum number of holdings required to reduce concentration risk, but only if these investments are uncorrelated in order to smooth the returns.

As an example the graph below shows the performance of Barclays bank shares against the Banking Sector over the last three years:



From looking at the graph it is clear that the blue line (representing the individual Barclays shares) has shown greater price movement, with more exaggerated shifts up and down.

This is backed up by the figures with the sector showing volatility over the three year period of 38.59 compared to Barclays at 80.05.

To put these numbers in context, if a stock had an average return of 5%

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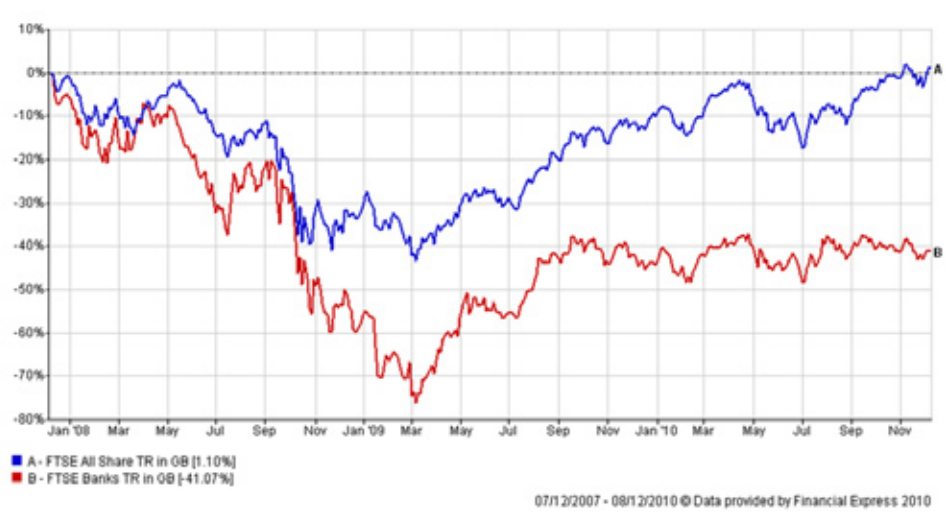
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over a set period and its volatility was 15, this would mean that the range of its returns over the period had swung between +20% and -10%. Barclays' volatility of 80 can be therefore be seen to be a huge number!

By having too concentrated a portfolio, your expected returns are much more unpredictable. Though both lines move in the same direction, the sector (made up of a number of holdings) is smoother when compared to the returns of the individual Barclays.

If you then compare the banking sector to the wider FTSE Allshare Index, you can see that, as a sector is much less volatile than an individual stock, so the wider market is much less volatile than an individual sector:



## Speculative focused

The above charts illustrate why we don't generally recommend buying funds that specialise in only a narrow area of the market, such as technology or mining.

As Warren Buffet said; "Only buy something that you'd be perfectly happy to hold if the market shut down for 10 years."

It is important to recognise the difference between short term speculation where the rewards may be high but risks absolute, and real long term investment where the goal is to make a steady return while minimising risk.

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# Market Views | December 2010

## General Economic Overview

GDP growth is expected to be muted but positive. We believe inflation may remain well above the Bank of England target for some time, and potentially be a concern in the long term. There is still a possibility of more quantitative easing in the UK which could increase long term inflation.

We believe interest rates will remain low throughout most of 2011 in order to stimulate economic growth. The combination of high inflation and low deposit rates hits pensioners the hardest.

If our scores below turned out to be correct, our balanced asset allocation could return around 8% pa 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 next year's projections are correct there is the potential for relatively strong 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>	+2
<p><b>Fixed Interest</b></p> <p>Gilt yields remain very low, making corporate bonds look reasonable in relative terms. However we do not believe gilt yields will remain at such low levels in the long term.</p> <p>If inflation remains high, fixed interest returns look less attractive despite low interest rates on cash. We now expect below average - but still positive - returns over 18 months.</p>	-2
<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 don't expect to see much more capital growth over the next 6 months. Growth may improve after that.</p> <p>Property funds are still sitting on high cash levels, which is a drag on returns. Returns should improve again once the strong inflows into funds reduce to more normal levels.</p>	-1
<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, and we don't see that changing 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.