

# Independent Financial Advice

# Investment News

from Johnston Financial

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## WELCOME

### Welcome to our first Investment News of 2012.

I said in the last bulletin that we ended the third quarter at the bottom of the rollercoaster and that at the start of the fourth quarter, major stock markets smartly reversed themselves and were rising. Well that lasted into November when they headed down again and proved that we were still on the rollercoaster. The good news is that at the end of December we were on the up slope and that has continued into January.

Economically little has changed. In the last half of 2012, markets took fright from a number of concerns and our contributors, Ken Forman and John Husselbee mention some of these. Largely these worries have not gone, the US may or may not slip into recession and as ever I have seen well argued commentaries reaching both conclusions. The UK may or may not slip back into recession and the Eurozone as a whole and many of its constituents probably will slip into recession.

The big question is will Greece default this year or next and if they do will they be forced to leave the Euro? If either or both of these events occur, what will be the effect on other weak Eurozone economies? And then, looking further afield, will China be able to engineer a soft landing for their economy? Their Government has just taken the first steps in loosening lending conditions again.

So as ever, there are both worries and opportunities and it is important to balance the risk taken against the opportunity available. John Husselbee makes it clear that he does not see this as a time to go all out for risk assets as some of the bad outcomes that might happen, could cause stock markets to fall heavily. On the other hand, now is not the time to be wholly out of the market as companies are in pretty good shape and if the Eurozone issue is resolved decisively, the relief rally could be big!

**Adrian M Johnston,**  
Managing Director



## Just how upset are the French!



Please excuse me if I indulge in a little schadenfreude (pleasure derived from the misfortunes of others). It was either comical or extremely annoying, depending on your point of view to see both the chairman of the French central bank, Christian Noyer, and the French finance minister, Francois Baroin, try to deflect the French credit downgrade by suggesting that Britain was in a much worse state and we should be downgraded first.

Well it didn't work. France was duly downgraded by Standard & Poors from AAA to AA+ with a negative outlook and the UK remains on AAA with a stable outlook.

Germany is now the only remaining Eurozone member with a AAA rating and stable outlook. In fact there are only 11 sovereigns left in the world who can boast this, these are:

Australia, Canada, Denmark, Germany, Hong Kong, Liechtenstein, Norway, Singapore, Sweden, Switzerland and the UK. You will note that not even the US is on that list after the political squabbling over their debt ceiling left them in serious danger of defaulting. However, it is the fact that there is absolutely no plan to get control of their spiralling deficit that worries the rating agency most.

The UK benefits from the international approval of our Government's Goldilocks debt control; not too much and not too little, as well as their downright relief that we control our own currency.

Does this matter? Well, yes. Our Government bond yields have reduced to levels that have not been seen in our lifetimes and along with bank base rate they are likely to stay low for some time. This is helping to recapitalise our banks and keep some consumer spending going as well as allowing the personal sector to pay down debt.

The markets may just have it right and lending to the UK is a better bet than lending to the French!



Ken Forman

# A View from the Top.

## Avoiding the Rocks

The global economy is sailing through dangerous waters but so far it has suffered no more than a few scrapes despite some unsteady hands on the bridge. But there is still some tricky navigation to do. The passengers (aka investors) are feeling

### History is littered with sovereign debt default events.

I recently came across a fascinating paper written by a couple of academic economists\* who have compiled a comprehensive database going back over eight centuries of countries that had defaulted on their debts. These events are far more common than I imagined and taken in aggregate offer some insights into their characteristics. One of the more striking features is the clustering of defaults into periods of around 20 years occurring roughly every 50 years. Figure 1 shows the percentage of countries that were in default in any year since the beginning of last century. The good news is that, if the pattern is sustained, we are several years away from another clustering period and the next peak is not due till around 2040. The last cluster included the Latin American crisis in the 1980s. There are many reasons for defaults including the after-effects of costly wars and weak financial controls in the public sector. Clusters of defaults have tended to be preceded by a surge of capital inflows to a group of countries. These inflows can be destabilising by causing debt service costs to become crippling and eventually governments can be forced to default.

### But history also illustrates that countries can successfully grow out of a debt crisis.

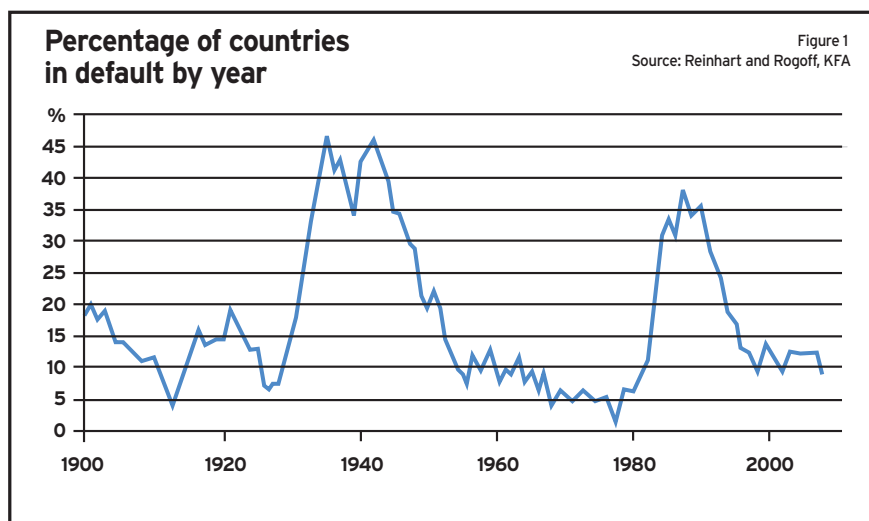
The UK provides one of the best examples of this. In the 1820s, the ratio of debt to GDP reached 250% (higher than any country at present) but over the next 90 years, this ratio was brought down to 40%. This was achieved through real economic growth rather than inflation. The inflation solution has been used by countries, including the UK at other times, to reduce the debt burden by transferring the cost to bondholders through an erosion of the real value of the debt service payments. More recently, Sweden was

able to cut its debt ratio from nearly 75% to under 40% without inflation in only 12 years through a combination of tax rises, spending cuts and, crucially, a currency devaluation against a background of strong global economic growth.

### Sovereign debt ratios are rising towards potentially dangerous levels across the developed world.

What started as a localised funding problem for Greece has escalated to the point where it has become a real threat to the continued existence of the euro as a common currency. Politicians have been slow to grasp the implications and stand accused of doing too little too late while they blame financial markets for causing the crisis to intensify. Various proposals have been suggested as a way to contain the problem and prevent a recurrence. But they all involve some degree of financial transfer from the stronger countries to the weaker and so far there does not seem to be an appetite for this amongst the former (notably Germany). Popular support for the euro is waning in various countries within the eurozone and it will be hard for politicians to implement legislation which will calm the markets. Nevertheless, a headline agreement is likely to emerge in time for the G20 international summit at the beginning of November. In the meantime, there is some good news from Ireland with its economy showing signs of recovery and the yield on Irish government bonds falling back from 14% to around 8%.

\* This Time Is Different, A Panoramic View of Eight Centuries of Financial Crises: Carmen Reinhart and Kenneth Rogoff, April 2008



more confident after a series of positive reports on the two largest component economies, namely the US and China. Even the perception on the eurozone crisis seems to have improved in recent months although

this particular rock still has the potential to hole the hull. We should not allow ourselves to become complacent though, as financial markets are likely to remain volatile, and we may hit a rock when we least expect it.

## EQUITIES

### Markets are continuing to recover from the end of September lows.

It's been more about a recovery in investor sentiment than about an improving outlook as earnings forecasts continue to be cut. The economic and political news flow has been reasonably supportive but as I have noted before, the economy is going through a series of mini-cycles and it may not be long before there are some negative surprises. Political developments also have the potential to cause investor unease.

Markets are generally offering reasonable value and dividend growth is likely to be strong again this year after rising about 15% in the UK last year. However, shorter term market performance is, as always, more likely to be driven by changes in investor sentiment than by valuation measures.

As we have seen all too often in recent years, sentiment can turn on a sixpence (or should that now be a five-penny piece!) and while it is has been recovering in recent months it is still quite fragile.

## BONDS

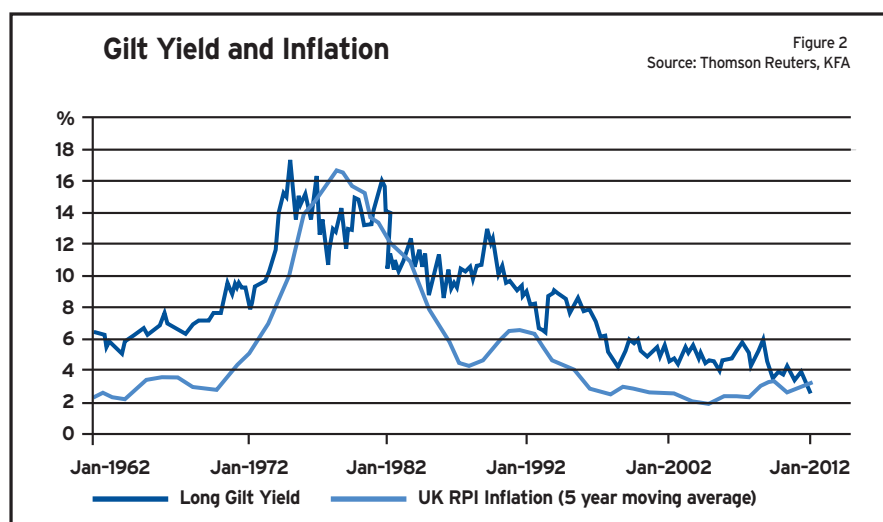
### 'Safe-haven' bond yields have continued to trend lower.

As I mentioned last time, these bond yields are unsustainably low but can go even lower in the short term. Investors looking to benefit from such a move should however be aware of just how far removed the current yield is from the norm and the risk they run should yields move back to the norm. In Figure 2, I show the history of the long gilt yield compared to a measure of inflation expectations.

Normally the long gilt yield is significantly above inflation expectations (taken here as the 5-year moving average of historic inflation) for reasons that space precludes from explaining here. The yield is currently over 1% below inflation expectations and as much as 4% below what could be considered a norm. The only other time in the 50 year history shown on the graph that the yield has been this much out of line was when inflation was at its peak and this model of expectations was giving a false impression. If the long bond yield rose back to the norm the price would fall by no less than 50% and the price of a 10-year bond would fall by about 30%.

## WHAT IS YOUR RISK?

Investment risk is often thought of as price volatility. While this is an important aspect of risk, particularly if investments have no maturity date, it does not capture the shortfall risk of the investment failing to meet expectations. Investors will have particular objectives and will construct a portfolio of investments which they expect to meet those objectives. Expected investment returns, however, tend to be best estimates which disregard the range of possible outcomes. While nobody will object to a more favourable outcome than expected, one that falls short of expectations can have serious consequences. When the returns are uncertain, investors should allow in their planning for dealing with the consequences of possible adverse outcomes.





# North Point.

John Husselbee, Fund Manager

## NORTH INVESTMENT

We may well look back on 2011 as a year that forever changed the economic and political landscape of the world, it has certainly proven no less eventful than 2008 for financial markets and we witnessed unprecedented volatility.

For Investors who started the year in an optimistic mood, fears of sovereign debt default in the Eurozone, rising inflation and a double dip recession soon readjusted their expectations. By the final quarter the relative calm of the first quarter was a distant memory, and heightened levels of volatility persisted. After two big down months in August and September, the October return represented the best monthly gain in the S&P 500 Index in 20 years. As we moved towards the year end the Eurozone debt crisis further intensified, and despite a number of 'rescue' packages announced by Eurozone leaders, the contagion continued to spread from the periphery towards the core. In the latest EU Summit, concluded on 9th December 2011, there was an agreement to move towards greater fiscal union between member states, however it once again lacked detail and financial markets demand more than just promises and move at a different pace to their political leaders. Gilt yields have continued to fall as the Eurozone sovereign debt crisis rages on and the politically induced downgrade of global economic growth from recovery to recession, which happened in a matter of a few days, led to a flight to quality. Defensive asset classes such as Gilts were pushed to record low yields and given our decision to be underweight in bonds and maintain a zero exposure to UK Gilts this has dramatically impacted the returns of the Nevis Portfolios since the middle of 2012 relative to their composite benchmarks, which have significant fixed weightings to gilts within them. However the performance of the Nevis Portfolios relative to the funds with similar objectives illustrates far less underperformance as many managers within the peer group

Nevis Portfolios Performance	1 Year 1Y 31/12/2010 To 31/12/2011	2 Year 2Y 31/12/2009 To 31/12/2011	3 Year 3Y 31/12/2008 To 31/12/2011
<b>Nevis Conservative Portfolio</b>	<b>-4.8</b>	<b>4.5</b>	<b>22.3</b>
IMA Mixed Investment 20-60% Shares	-2.1	6.4	23.2
Benchmark	5.7	17.9	31.6
<b>Nevis Growth Portfolio</b>	<b>-8.1</b>	<b>2.6</b>	<b>20.3</b>
IMA Mixed Investment 40-85% Shares	-5.6	6.1	27.3
Benchmark	1.5	14.8	31.9
BofA Merrill Lynch UK Gilts All Stock TR USD	15.7	24.0	22.6
MSCI United Kingdom TR	-1.8	10.2	40.7
MSCI World ex UK TR USD	-4.6	10.9	27.9
IPD UK All Property Monthly TR	8.1	23.7	26.4

Source: Lipper Hindsight Bid to Bid, Income Reinvested

share our negative stance on gilts. The returns of these respective peer groups are represented in the performance table by the IMA Mixed Investment 20-60% sector for Nevis Conservative and the IMA Mixed Investment 40-85% sector for Nevis Growth.

Over this final quarter and the last twelve months, we have maintained a cautious approach and have maintained a neutral weighting in equities versus the benchmark, but favour managers with a focus on companies with strong balance sheets and good dividend track records such as the Aviva US Equity fund, which we added to the Nevis Conservative portfolio in December, and the Lindsell Train UK Equity Fund which was added to Nevis Growth portfolio in November. Both of the Nevis portfolios have been underweight in bonds, and we have favoured credit and short duration strategies such as the Muzinich Short Deviation High Yield fund which we topped up in November due to the continued fear of monetary tightening in the UK as inflation remained significantly above the Bank of England's target.

As regards the rest of the fund during the fourth quarter, the equity position was a positive contributor due to the defensive nature of the majority of active equity managers, particularly in the Asia Pacific region where the portfolios are invested in Newton Asian Income, First State Asia Pacific Leaders and the Schroder ISF Asian Total Return fund. Commodities were softer but the Fund was protected to a degree by the decision to reduce our exposure in the second quarter.

Finally, the decision to maintain cash in excess of benchmark throughout this period limited the underperformance in the quarter to some extent.

Looking ahead to 2012 our strategy with the funds will remain cautious and periods of significant strength in equity markets may provide an opportunity to take some risk off the table. The equity weighting remains largely defensive, where balance sheets are strong and companies have notable exposure to the growing areas of the world. However, there is also a strong case for investing in companies where valuations are compelling, such as Japan and parts of Asia ex-Japan.

UK and US government bond yields continue to sit near record lows and represent poor value. Within fixed income, the Fund will continue to favour credit over sovereigns and retain, where possible, a bias toward quality strategic bond managers. The need to have exposure to non-correlated assets is greater than ever and a global macro hedge fund was recently added to further increase diversification within the portfolios.

The high cash weighting continues to provide an element of protection for the Fund against falling markets. In order to become more fully invested a clear and more detailed plan outlining the future strategy for the Eurozone is necessary, along with signs that credit strains within the Eurozone are easing. The recent improvement in US economic data is welcomed but must be sustained and still lags what would be expected in any normal recovery.

### Important Notice

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