

To the Clients of Michael Barr and Co Ltd.

How many times does the end of the world as we know it need to arrive before we realise that it's not the end of the world as we know it?"

— *Michael Lewis, editor of the book of essays 'Panic: The Story of Modern Financial Insanity.'*

As I am writing during a recession, possibly one of the worst since WW2, I wanted to spend a few minutes confirming my experiences of investment and portfolio construction. When I go out and about it is quite clear that very few of us understand how investing works, and hence I hear and read about the old myths and what my late Mother would refer to as 'old wives tales'.

I wanted to start by explaining my thoughts on defensive assets. When you put a portfolio together the first decision should be about how much you want in growth investments- generally stocks and shares, and how much you want to be in defensive assets. The more you have in defensive assets the less profit you will make in a good year but you lose less during the bad years.

During 2008 many investors learnt the hard way that risk and reward are inseparable, and you cannot have a high returning investment with low risk. There are times when it seems you can have a low risk investment and a high investment return, but eventually the losses experienced prove what I say.

One of the major variations in our portfolio construction approach, compared to what you would be advised if you were a bank or stockbroker client for example, is that the defensive part of your portfolio is limited to short-dated high grade bonds and Government-backed securities. This level of security restricts the potential return, and I have no expectation of making a very good return from our defensive asset classes.

The benefit, which is clear to see this year in our balanced and lower risk portfolios, is that the overall losses have not been very painful at all compared to what you would have expected after viewing the press and national news. The major factor has been the positive performance of the defensive assets.

I now see investors are being offered bond funds claiming a yield of 9%, which look amazing compared to what you can get in any fixed rate deposit account. I expect many investors will be tempted to move from low interest cash deposits into these high yielding bond funds, but what is overlooked is that the 9% income is the reward for accepting a high risk. Investors may indeed get away with 9% and suffer no damage to their capital and good luck to them, but I can tell you that it is not beyond my imagination to see such funds fall by 10% or more in value. If an investor experiences a capital loss, this converts that super income into an easy way of reducing wealth.

The problem for many investors is the need to generate more income, as interest rates are so low, and quite naturally they will look at all the bond funds marketed, and assume that the word bond implies safety. Regretfully, the list of casualties through high yield bond funds is already longer than the number of zeros attaching to Iceland's national debt.

So, our strategy on defensive asset classes has been vindicated. Regretfully it takes a period such as this to prove the point.

It's also worthwhile discussing cash deposits now the base rate is a record low of 1.5%. Cash deposits are great for the short term but as a long term investment the evidence shows them to be unattractive if you are concerned about inflation. In fact, we have just seen the end of a very unusual period in history when it has been easy for a saver to earn a return on their cash which is comfortably above the rate of inflation. I remember that in the early 1990's investors could invest and earn double digit net interest of 13% or more, but savers forgot inflation was always higher.

Sometime ago, we advised all clients with over £30,000 in a deposit account to diversify to maximise the available compensation in the event of a failure. Well, to quote on this advice at the time, the unthinkable did happen. This gave us peace of mind when Northern Rock went bust followed by a stream of established banks going to the wall. With Government intervention, it seems unlikely that any investor would lose during the failure of a UK registered bank today, but had it not been for the Treasury's interventions, those holding large sums in deposit accounts would have experienced one of the worst savings disasters.

One myth that I am happy to see exposed is the idea one can make 10% or more each year when everything else is falling in value. Such strategies involve betting with your money, and I am still disturbed that so many people would invest millions of pounds into funds and not have any idea whatsoever what is going to happen to that money. I am talking about Hedge Funds which were extremely lucrative for the managers who managed to strip out obscene levels of fees before the whole concept went pear shaped. As is often the case with these things, they work initially, and a little bit of good past performance sucks in the really big money before the funds implode.

I am also hoping that the property collapse will help people to think more about sensible investment strategies over the longer term. I have nothing against property investment. What I am against is those who believe they can plan to swap a big house in the future for a smaller house to create a retirement pot. Or buy to let property with a huge mortgage should always have been a non-starter. Unfortunately, as with any speculative bubble, many investors will not listen to sense until they begin to suffer the consequences of muddled thinking.

The FTSE All Share Index fell by nearly 30% last year, and with the fall of the pound against almost all other world currencies, the United Kingdom is not going to be the world's favourite place to invest for a while. It seems the Universe has assessed Great Britain plc, looked at its debt situation and economy, and given it a big thumbs down. This is the simple explanation for the collapse of the pound as the huge national debt is going to be a burden for years.

Stock market returns have been very poor this year. Our index funds, which are the heart of our growth assets, avoided the real damage that others have often suffered by holding concentrated portfolios. For example, I have come across investors who invested heavily in bank stocks and construction companies which seemed a good idea at the time. Often such portfolios have been damaged to such an extent that standards of living are going to be affected, and all in the mistaken pursuit of outperformance, and the impossible-to-measure exposure to losses. One hidden advantage of our index strategies, that of owning a share of an entire stock market, is the avoidance of such under-performance,

I am constantly sifting through the evidence, and it doesn't take much of an academic bent to see how badly some of the so-called clever active fund managers have done in 2008. When a market is down 30% and you see others down 40%, 50%, 60% or more, what are they going to do? Do they hang on hoping there will be a recovery of biblical proportions or do they run up expenses hoping to catch the next big winner? We do know the markets will always recover, but not many speculators survive for long.

It is common sense to say we could not have foreseen the events of 2008, nor can you predict them ahead of any year, including 2009. It is a great advantage when you come to understand there are just so many things beyond our comprehension and unknowable. Sometimes though, I do express a view that can be mistaken for a forecast, when I am explaining what is clear after studying the evidence. For example, I know that our investment strategies will beat $\frac{3}{4}$ of all other active strategies over ten years, and with less risk and expense. Anyone who says otherwise is attempting to deny the laws of maths, statistics and economics.

There have been over a dozen major declines in world stock markets between 1946 and today. That is, major declines in which frightened investors could have spent lengthy periods adding up their 'losses' every night, to the point of insanity. I guess we are now in the later stages of the largest of those declines.

In more than one newsletter this year I have mentioned the world's most successful investor. Warren Buffett's personal wealth, which is nearly all in stocks, was recently stated as being down by ten billion dollars. A journalist asked him how it felt, to see his wealth go down over 40%. Buffett's reply was that it felt pretty much the same as it did the half-dozen or so other times it's happened to him over the last fifty years.

He would be the first to tell you, he hasn't lost anything because he hasn't sold. In fact, he could tell you about having 'lost' \$347 million on Black Monday, October 19, 1987 and a decade later, in just 45 days during the summer of 1998—when Russia defaulted, Long-Term Capital Management imploded and the emerging markets collapsed he 'lost' \$6.2 billion. Buffett would say he was experiencing temporary price declines, which were dwarfed by the wealth he accumulated when the long-term uptrend resumed.

When you experience a world where stock markets have been down 50% or more, and where it is fair to say that the value of just about everything has gone down a lot, and some bank savers would have lost everything had it not been for unlimited Government compensation, you are going to have concerns.

We can say that the experience of the world's most successful investor is not typical, but it is certainly worth noting. The markets' indices, excluding dividends, and at today's depressed levels, are up about five times since October 19, 1987. And there have been at least three bear markets between then and now.

If throughout all of these periods one had stayed broadly diversified with high quality investments, there was really only one way for the long-term investor genuinely to lose anything. It was to mistake a temporary decline for a permanent loss, and then to panic and sell out. A major part of long-term successful investing is the decision not to make such a mistake.

I was out to a rugby match this last weekend and the few conversations we had about investments, between watching very big men hammer each other on a freezing night, could be condensed into two themes. The first was wouldn't it be better to keep our money under the bed or just buying safe investments. The second was that it must be very difficult for me to have any good ideas of where to invest.

Years ago, I was speaking to a building society manager, who was based in Cleveleys and he said the best weeks for building societies were when some pensioner was reported to have had their life savings stolen from the house. This meant pensioners opening new accounts in droves as they realised the stupidity of keeping money in the house (with no investment return). Buying only safe investments, that often turn out not to be safe, is simply to follow the worst instincts of the herd. Those very same people will start leaping into stock markets after stock markets have recovered.

On the second theme, I hope it is no surprise that I know exactly what we should be doing, and that is continuing with our present strategies. Having separated out the savings needed for the short term, you own a portfolio with both growth and defensive assets to fit your own personal financial plan. This must be planned and personal because a goal without a plan is just a dream.

We should not involve ourselves in too many conversations about how long it will take for the markets to come back, a variable which is unknowable and therefore unhelpful to someone's long-term financial planning. However, the historical facts are that twelve-month returns during the recovery of the ten previous post war recessions have averaged over 30%.

At the moment, the psychology is all negative, and any good news is swept away and only the bad news is discussed. This morning the retail figures for December were given as a disaster, down a massive 3%. A spokesman was asked if the 2.5% drop in VAT had helped. The answer said it has but the number, 2.5% was so small, it made very little difference. So when it suits, 2.5% is a small number and 3% is a big one.

With an endless stream of bad news from the financial press, BBC and ITV news it can be a dangerous time for investors who can damage themselves. This is a time when some investors give up and sell their stock market investments. They are selling when prices are low, and therefore making sure they miss the eventual recovery.

In past recessions and downturns, this brushing of any good news to one side is a common feature, and of course this adds to the gloom. Eventually, there is a reversal. Stock markets always anticipate the end of the recession and the best of the recovery is usually missed by those who choose to wait until things settle down, which they never do.

One consequence of current events is that you may never again in your lifetime know so many people, so desperately in need of good advice and so thoroughly disenchanted with their current financial adviser. The published figures for investments being sold, show that there are thousands who are not at all happy with the financial advice they have been getting, and they at least need the benefit of a second opinion.

Michael Barr 14th January 2009

Michael Barr established Michael Barr and Co in 1982. In this time Michael has established a strong reputation for integrity and professionalism. His qualifications alone demonstrate an impressive level of commitment. He is the first in his profession in the North West to be awarded the Fellow of the Personal Finance Society - the highest qualification possible. He is a Certified Financial Planner and a Chartered Financial Planner, a rare achievement in the industry. He is also a Fellow of the Chartered Insurance Institute (Pensions) and holds the Advanced Pension qualification, G60, and the Investment Management Certificate of the CFA. In addition, Michael is a winner of the National Planned Savings 'Personal Financial Planner' of the year award and a host of other national awards.

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