

Where do we go from here?

At the beginning of this year there was hope that the global quantitative easing programmes of 2009 would see world economies stabilise and that we would come out of the global recession slowly but surely.

How wrong could we have been as the past six months have been a very trying time for investors with a new catastrophe appearing to happen every few days? To name but a few of the examples we have seen this year, the oil spillage in the US and its effect upon BP, the sovereign debt crisis in Europe, a hung parliament in the UK, all the European Banks subject to stress testing, media speculation over a “double dip” recession and the China bubble bursting, the most severe UK budget for generations to be followed by a proposed comprehensive public spending review this Autumn. All good doom and gloom fodder for the media, but what has really happened in the economy this year?

Despite all of these occurrences which singularly or collectively could have destabilised any economy the fundamentals remain strong and many businesses, especially those with strong balance sheets, have remained firm. Whilst the FTSE 100 Index represents the top 100 UK Companies by capitalisation it is not wholly representative of the UK market, but gives a good indication of global markets. At the start of the year it stood at 5,250 and at the time of writing it is slightly ahead of that same number. Therefore, at first glance, it could be judged that the UK economy has been static so far this year.

Well, we all know that is not the case because during this period the same Index has been as high as 5,825 and as low as 4,805, a difference of nearly 20%. This has been reflected globally and from an investor’s point of view there have been some good opportunities and some fund managers have exploited them to their clients advantage. As multimanagers investors, we at Dentons seek these active managers so that you as our clients get the benefit of their expertise.

A question that I have been asked by a number of investors this year has sounded like “where do we go from here?” Whilst trying to give an encouraging answer, I’ve often said to myself that would be easier to answer if I knew where “here” was. If we had listened to the noise created by the media, we would believe that the world economically is in limbo with meltdown just around the corner and that investment advisors should not be listened to or trusted. Of course, I would argue differently, but it is in these current difficult economic conditions that investors need advice more than ever.

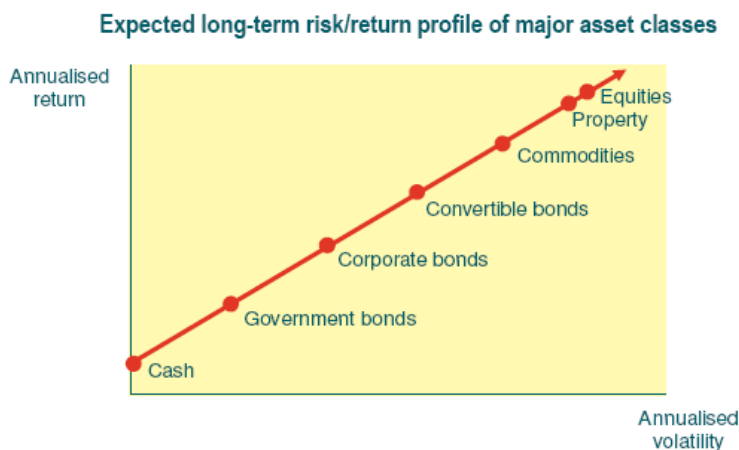
The old, often quoted adage is “the key to successful investing is to have a spread of investments across the various geographical, risk and economic sectors and to make sure that they are actively managed”. This is very true today.

I would like to talk about risk and people’s perception of risk. We all know that holding cash is the lowest form of investment risk....or is it? As part of the government’s economic recovery programme and to ward off the full effects of the recession in the UK interest rates were reduced. In March 2009 the Bank of England Base Rate was lowered to 0.50%, its lowest ever level. A year earlier it had stood at 5% and today 15 months later it is unchanged at 0.50%.

Throughout most of this time inflation has been at a greater level than interest rates, so anybody investing into this asset class has seen the real value of their capital go down, especially if they are drawing an income. Analysts who six months ago predicted that rates would be raised in the second half of this year are now saying that rates will not go up until the second half of next year. It looks like a long twelve months for those who persist in holding money on deposit. So, are deposits low risk? Yes, but at present they’re also low return.

The usual perceived scale of risk is shown in this illustration.

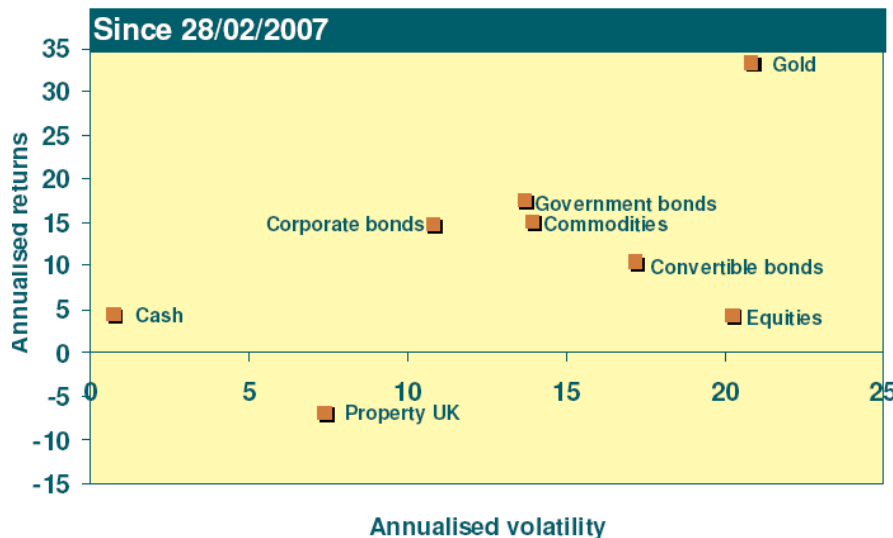
Received wisdom is that risk is rewarded with return



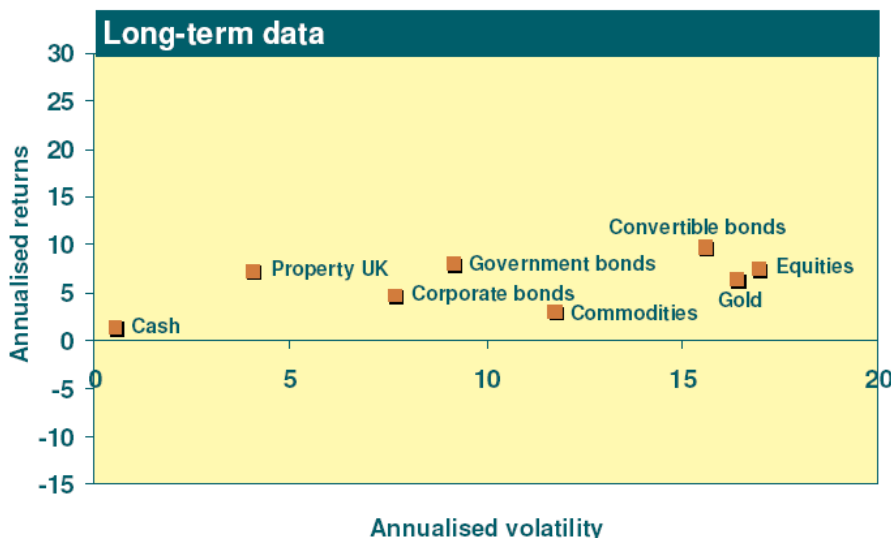
But it doesn't always happen in the real world...

Theoretically, long term, high risk assets have higher expected returns associated with them. So cash, with minimal volatility, will have a certainty of return, while equities at the other end of the risk scale may generate higher returns. But these returns can be unpredictable. This is received wisdom, though seldom followed in practice.

The reality however demonstrates that there are huge dispersions of risk and return over time. The following table shows the returns received for the risk taken over the past three years for the assets classes shown earlier and also includes Gold, which has had an outstanding investment period.



The same data shown over the longer term, this time more than ten years, demonstrates that no single asset class dominates and that these dynamic changes between asset classes argue the need for dynamic asset allocation.



.....and finally. Looking forward, our investment views believe that recent equity performance will continue slow but sure with the long term outlook better than the short term. Driving factors will be the growth stories from the emerging markets. We believe that short term interest rates and inflation will remain benign, thus better value can be obtained from assets other than deposits. Debt concerns weigh on mainstream government bonds and we therefore favour non-mainstream (not UK, Europe and US) government issues.

Source of all tables: M&G UK. July 2010.

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