



## September 2001 - Special Edition

### Investment Commentary

Are we in a bear market? I think the simple answer is yes because at the time of writing the FTSE 100 Index, at about 4,600, is down almost exactly a third from its peak of 6,930 at the end of 1999. The graph below shows the FTSE 100 Index during this period.

FTSE 100 Index



Most people agree that a fall of 33% qualifies for a bear market, so the depressing decline experienced in the last couple of years could be over. Two years also feels like the sort of time a bear market should last. So that's the good news.

My suspicion, however, is that there is further to go. The market likes big round numbers when contemplating turning points and my guess is that this time a halving from the peak (i.e. down 50%) is what the market is gearing up for. I think this is reasonable, partly because the market was very expensive in a historical context at the end of 1999 and partly because investor confidence has further to fall (I will discuss this in a moment). If the market halves from its peak (i.e. the FTSE 100 Index going to about 3,500) the market will then be yielding just over 4%. This feels reasonable to me given that inflation is still low. Identifying a theoretical base is pointless at one level (particularly for us since our investment approach, The Liontrust Large Cap. Process, does not require us to have any view on where the market is heading) but at another level it helps one cope emotionally with a market which is going down. If one is looking to invest in a bear market, either in a professional capacity, or as an individual, it is sensible to identify a level at which you are happy to buy, however gloomy the near term prospects. A yield on the market just

in excess of 4% is broadly in line with the historical numbers we quoted in our recent study document about investing for income: “The Liontrust Value Dynamic”. Personally, if the FTSE 100 Index falls below 3,500 I shall be closing my eyes and jumping in.

Despite the prospect of the market falling further from here it is worth remembering why market timing is such a dangerous game. When the market decides to go up it usually goes up when investors least expect it, and moves very sharply. As an example of the risk in missing the turn when it comes, consider the following fact. A dollar invested in the S&P 500 from January 1960 to June 1990 would have compounded up to \$19.45. If, however, you had been out of the market for the 10 best individual months of those three decades (ie. less than 3% of the whole 30 year period) the value of your dollar at the end of the period would have been only \$6.58 (a return equivalent to holding cash). The numbers are similar for the UK market. **The moral is clear: if you are investing for the long term, remain fully invested, whatever your view of the market.**

The price of equities at any given time is, ultimately, a function of risk and reward, i.e. how much reward do people like you and me require for the risks we are taking in holding equities. The experience of most of the last two decades (when equities have gone ever upwards and investors have got used to ‘buying on the dips’) has meant this relationship has got out of balance, i.e. investors are now prepared to accept too little reward for too much risk.

This kind of debate usually leads into a tedious discussion about Equity Risk Premiums (not a subject to get the heart racing). The Equity Risk Premium is just a complicated way of trying to measure investor confidence. Confidence is the secret ingredient in gauging where the balance of risk and reward lies at any given time. For an equity market strategist it is necessary to try and assess this; factors such as corporate profits and interest rates are important but investor confidence is usually the intangible factor which determines the timing and magnitude of any move in the equity market.

For most of the 1990s equities were ultimately driven by an environment which was so positive that it enabled investors to be confident about almost everything in regard to the market. The main driver was the collapse of inflation which enabled gilt yields to fall; in tandem with higher profit margins all news was generally regarded in a positive light: confidence was high and for investors the investment glass was usually half full.

A subtle change started about three years ago. By the middle of 1998 it had finally become accepted wisdom that inflation would stay low (an independent Bank of England playing an important part in this belief). This acceptance of a world of low inflation started a shift which meant that investors would increasingly view the investment glass as being half empty. The real joy of falling inflation for investors was that even in those periods when profits were lower than expected, lower gilt yields (because of the lower than expected inflation rate) meant that investors could justify ever higher equity prices. (A well paid equity strategist armed with his equity risk premiums, dividend discount models, inverse yield ratios and inflation adjusted whatevers can justify almost any level of the market).



As low inflation became accepted as the norm a problem arose. At a simple level the major driver of the market during the 1990s (i.e. lower than expected inflation) had been removed. Now even lower inflation meant potential deflation which was interpreted as being very bad for company profits (and therefore bad for equities, whatever gilt yields did) while a bounce in inflation was also deemed to be bad for equities because gilt yields and interest rates would have to rise (the 'bonus' of higher profits now being ignored). Even if investors could not think of reasons to sell, they could certainly think of reasons not to buy.

This shifting pattern of investor confidence is nothing new in the market and helps explain what, in retrospect, seem like extreme valuations (both high and low). When confidence turns into over-confidence the seeds are sown for the kind of bubble which drove the technology stocks to crazy levels last year. From a purely stock market perspective, I think the main damage caused by the appalling terrorist attack on the World Trade Centre in New York is on confidence. It is reasonably obvious that the US economy (which was clearly slowing before the attack) will suffer; what is much more difficult to assess is what the ramifications of lower confidence in general are and how long these effects might last. Trying to be too precise is pointless but I think people have been so shocked and upset by the events in New York that confidence in general will suffer, and equities in particular, will be adversely affected. Today, the investment glass is definitely half empty.

In time this will change. It is right therefore, that all investors try and gauge where their own balance of risk and reward lies. For me, as I said earlier, a yield on the market of about 4% feels sufficiently attractive to make me feel as though I'm being rewarded for the risks I'm taking.

Luckily, from the perspective of our investment process, we do not try and forecast (guess) the "correct" level of the market. It is important, however, to have an investment process that can still do well in a market which is going down as well as up. It is also important to anticipate what sort of stocks may benefit or suffer in different market conditions.

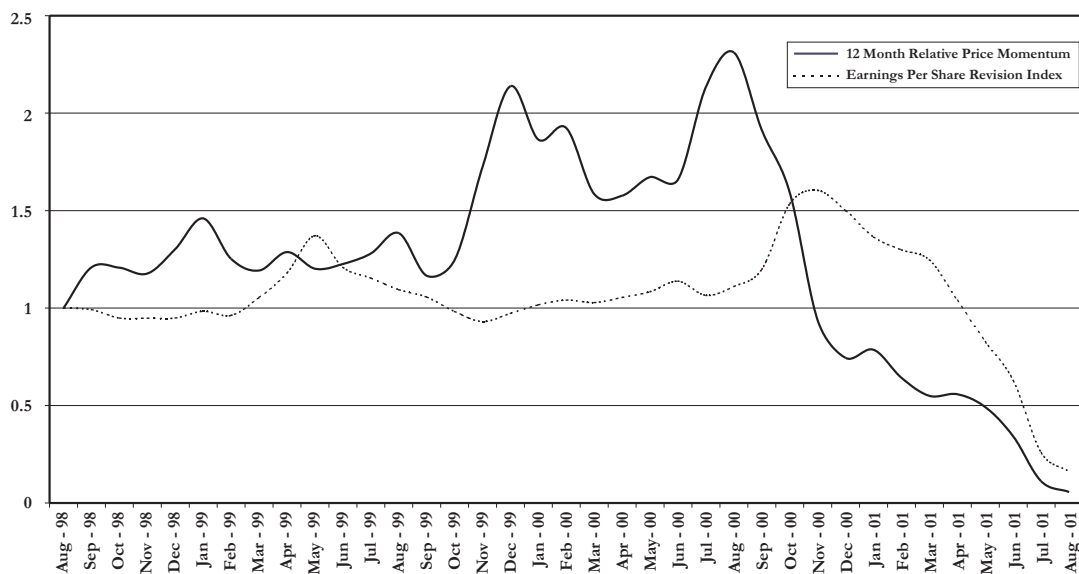
As regular readers of *Common Sense* will know, the stocks in the portfolio will be determined by the companies we identify where prospects are improving. This is what drives our stock picking; not any macro view of markets or interest rates. What has happened over the past year is that a number of previously strong themes (such as technology and outsourcing) have run their course and a greater variety of stocks are now surprising in a way which is driving their earnings forecasts ahead of expectations. We have identified many attractive stocks but they are very different from the ones held in the portfolio a couple of years ago. In addition, because these stocks come from a wide range of sectors it is harder to identify any particular theme running through the portfolio. One (less obvious) theme remains the increasing importance of income. As I discussed in last quarter's *Common Sense*, if we are right in our belief that income is likely to be an important driver of relative returns for the foreseeable future, then a greater proportion of stocks purchased for the portfolio (both 'winners' and cheap middle ground stocks) will have attractive income characteristics.



This has again been the case with the review we have just completed for the portfolio. We have purchased three new ‘winners’: *Amersham*, *Bradford & Bingley* and *Incbcape*, and have added to our holding of *Rentokil Initial* (which we bought in the previous quarter). The only new stock we have purchased in the middle ground is *Stagecoach*. A number of stocks have been sold of which the majority are either technical ‘losers’ (e.g. *Reuters*, *Celltech*, *Energis* and *Close Brothers*) or stocks which are no longer ‘winners’ (e.g. *Amec*, *Bioglan Pharma* and *Amvescap*). In each case we had reduced the weighting of these holdings earlier in the year to less than 0.5% as we felt the investment risks were increasing. We have also sold *Reed International*, *Sainsbury* and *Allied Domecq* as we have identified more attractive stocks in their respective sectors. The net result of all these changes is that the number of stocks in the portfolio has fallen from about 75 to 64, an unusually large move for a single quarter.

A review of the quarter would not be complete without mentioning *Marconi*. It is worth discussing in some detail partly because we did hold the stock during 2000 and partly because I still find the events of recent months almost unbelievable. The way *Marconi* has unravelled in the past year must rank as about the most amazing corporate story of the last 20 years. Before looking at what happened in more detail I have shown in the chart below the two quantitative factors which help us decide whether a stock has the potential to be a winner or is in danger of becoming a loser.

3 Year Marconi Graph



The earnings revision index line shows how earnings per share forecasts for the year ahead are moving (on a rolling three month basis); i.e. when the line is moving up profit expectations are rising and when the line is moving down profit expectations are falling. The 12 month relative price momentum line shows how *Marconi* has done (relative to the market) in the last year; this currently shows that *Marconi* has lost about 97% of its value in this period.

For most of 2000 everything was fine: the world of telecoms equipment manufacturers (into which the old *GEC* had been strategically thrust, accompanied by a change of name) seemed to be



growing nicely. The problems, however, started in the final quarter of 2000 when a number of US companies made references to a slowdown in the industry. This was confirmed to a more UK-centric audience when a number of telecoms-related manufacturers in the UK (like *Spirent* and *Voalex*) warned that life was getting more difficult. From our perspective the deteriorating newsflow during the fourth quarter of 2000 meant that *Marconi* was no longer looking like a winner; ironically our decision to sell was made easier by the fact *Marconi* had become a technical loser by the time we did our quarterly portfolio review in December (i.e. it had negative eps revisions and fifth quintile share price momentum). So we sold *Marconi* in the first week of January. This was straightforward, even if selling at 701p (down 44% from the high only four months earlier) felt uncomfortable. *Marconi* may be an extreme example in terms of the fall in the share price (particularly given its relatively recent status as the UK's premier industrial company) but it is a good example of why holding on to losers for too long is so damaging to relative performance.

The collapse in the *Marconi* share price is understandable when one considers the events of recent months. The profits warning announced in July was deemed to be so bad by the company that the shares were even suspended for a day. The end result has been that the £2.6bn cash mountain Lord Simpson inherited from Lord Weinstock five years ago has been turned into £4.4bn of debt. Having made an operating profit of £658m in the year to March 2001 analysts now expect *Marconi* to make an operating loss of at least £150m in the current financial year. More specifically management has made provisions of £500m for inventory, £3.5bn for goodwill and £150m for doubtful debts. This has resulted in shareholders' equity falling from £4.6bn to £0.4bn. The principal culprit in the writedowns has come from *Fore Systems*, the US Internet switching equipment maker which *Marconi* bought for £2.8bn in 1999 and is now estimated to be worth less than £200m. You don't need to be a qualified accountant to know this is a tale of serious shareholder destruction.

If the raw numbers weren't frightening enough on their own, when the finance director was asked why *Marconi* was writing off £3.5bn of purchased goodwill only two months after flatly denying any such intention he said "we've run a different set of assumptions on sales forecasts over the next number of years. In an increasingly volatile market, we have to put the business in a position where it can operate effectively even if there's no growth from where we are today". Whatever his intentions this kind of comment does not reassure investors and confidence in general suffers.

Ignoring the rights and wrongs of the whole *Marconi* saga, it demonstrates clearly the danger to investors if management add financial risk to industry risk. There is nothing wrong in massively gearing up the business (in terms of the balance sheet) to take advantage of some 'strategic vision' as long as your shareholders really understand what is being done. The risk, obviously, is that if an unexpected downturn comes along in your industry you can go bust if your balance sheet can't take the strain. I would guess most shareholders in *Marconi* didn't really understand the risks they were taking for the rewards on offer. Part of the problem lies with the structure of option packages for many chief executives and senior management which encourages firms to go for rapid growth (and a higher share price) rather than a more prudent (and less exciting) long term strategy. I'm sure at a subconscious level this has been a factor in the *Marconi* boardroom in the last four years.



As we move into the last quarter of the year I suspect most fund managers are feeling a little weary. This is partly because bear markets are depressing places to be working. From the perspective of our investment process life has been getting more difficult because the number of companies which are persistently surprising has been falling (by our definition these are the companies where earnings have been revised up for at least two successive quarters). With the prospect of an economic slowdown (and possibly a full recession) on the horizon, analysts are most likely to be reducing earnings forecasts for the majority of companies in the coming months. As a result life will remain difficult.

So far this year we have still managed to identify enough 'winners' to make us feel reasonably confident about medium term prospects. The portfolio has, however, been relatively defensive in its structure (particularly at an individual stock level where I have been keeping the weightings of individual 'winners' in the portfolio relatively low). This is likely to remain the case until we have greater confidence in the outlook for the market and, in particular, see the number of stocks persistently surprising rising again.

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