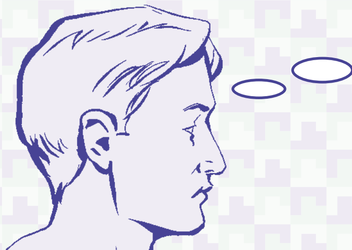
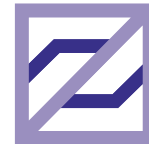


COMMON SENSE

A periodic bulletin for portfolios managed by William Pattisson in accordance with The Liontrust Large Cap. Process



LIONTRUST

Reissue of September 2001 - Special Edition

With the market falls this month and last we thought you'd be interested to read again William Pattisson's view of the UK market written last September.

Investment Commentary

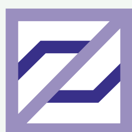
"Are we in a bear market? I think the simple answer is yes because at the time of writing the FTSE 100 Index, at about 4,600, is down almost exactly a third from its peak of 6,930 at the end of 1999. The graph below shows the FTSE 100 Index during this period.

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 (ie. 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 (ie. 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 you had, however, 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 only been $6.58 (a return



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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, ie. 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, ie. 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 (ie. 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, therefore, right 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 like 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. ”

William Pattisson, Investment Director.
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