



APRIL 2010

We have two short pieces for you in this quarter's Diary -

1. How to pay the right price for an investment and 2. Residential property: the legacy of debt

## HOW TO PAY THE RIGHT PRICE FOR AN INVESTMENT

### Value will out

We are essentially 'value' investors. We hate paying more than an investment is worth. In addition, predicting what will happen to a stockmarket in the short run is an impossible task (who would have thought a volcano of ash was due to occur and who could predict whether or not stock markets would react?)

Hence our methodology is based around identifying long term, undeniable trends and themes, such as the increasing global need for infrastructure and the ageing global population. We then look for opportunities to capitalise on those trends without overpaying for the privilege.

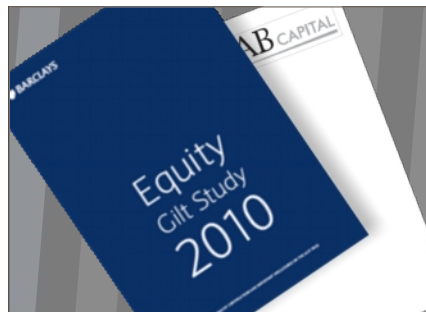
### Rational analysis

We consider the widest range of inputs as part of our investment process, from fundamental grass-roots company analysis, through behavioural finance, to long term 'Kondratiev style' super cycle analysis. We consider it blinkered to focus on one particular investment style or school of thought. At the very least, if some traders or investors are using a certain form of analysis, we need to know about it, because their presence will have an effect.

### New research and original thought

We would like to highlight two pieces of work which have caught our attention:

First, in the 2010 Barclays Equity Gilt Study, Tim Bond showed how market crises in recent history have been a product of trends in global savings flows. The demographic pattern caused post war baby boomers to create abundant liquidity as they reached middle age. This resulted in misallocations of savings, driving up asset prices and creating asset bubbles. Over the coming years, savings flows are likely to diminish as the baby boomers retire en masse, causing the reverse effect on liquidity. This will mean that future growth in equity markets will have to come more from real earnings growth by companies rather than just relying upon excess demand for shares causing prices to rise.



Second, we note the excellent ongoing analysis entitled 'Market Cycles' created by Dhaval Joshi at

RAB capital. Most recently, Dhaval has presented cogently that the global economic cycle over the last decade has been accurately determined by the aggregate credit cycle of the US and China. When the combined borrowing of US and China has accelerated or slowed, global activity has followed suit.

The unfortunate truth here is that combined US and Chinese borrowing cycle is turning down, with obvious implications for the global economy. Governments, firms and consumers are under significant pressure to get their balance sheets in order, and specifically this means paying down debt. We expect global growth to undershoot forecasts over the next few years, with the inevitable impact on sentiment. Whilst equity markets aren't actually tied to the fortunes of the global economy, they do tend to follow sentiment, and we expect sentiment to turn away from the recent levels of over optimism. In fact, this shift is happening as we write.

### Sell in May and go away?

*(The original adage is "Sell in May and go away, stay away till St. Leger Day", which refers to the long held belief that the period from November to April has significantly stronger stockmarket growth on average than the other months.)*

We can't say for certain whether the world has truly bottomed out from the effects of the credit crunch, and we do not expect equity markets to maintain their 2009 growth rates. Indeed we see some significant draw-downs in the second half of 2010. Oddly, the UK equity market is somewhat protected against

significant draw-downs due to the international nature of the earnings of the underlying companies. Over 70% of FTSE 100 companies' earnings come from overseas, and the weakness of sterling has increased the value of those overseas earnings.

### Applying behavioural analysis to our own thought process

Humans tend to search out information which supports a view they already hold. This is known as 'confirmation bias'. We try hard not to ignore positive news that opposes our view, and not to focus on the negative news which supports our bearish view. However, we also know that humans have a tendency to be over optimistic, and so we know we are generally better off maintaining a sceptical disposition.

Balancing these two elements is one of the bigger challenges we face today. At the beginning of the year, we highlighted some significant risks that the world could face in 2010. Some of these challenges have raised their ugly heads (Greece); some still lurk in the shadows (expected loss of confidence in the public finances of US and UK).

### So how does this translate into strategy?

We maintain a defensive stance. This is no time to be taking on more risk just because the market seems to suggest everything is hunky dory. In addition, this means:

*We diversify significantly.* There are plenty of opportunities to capitalise on the many ongoing inefficiencies in the global economy which were created by the credit crunch. Investors don't need to go fully long or short the equity market to take advantage of the new investment environment.

*We maintain a 'value' approach.* This is a recommendation for life in investment terms, but is even more pertinent when the global economy faces so many challenges and imbalances. Value strategies did not have a good year in 2009, but we maintain it is the safest, and in the long term, most profitable investment style.

*We remain opportunistic.* Volatility will bring opportunities. In the final phase of the bear market/end of the credit crunch, the greatest opportunities present themselves. We are well positioned to take advantage of opportunities as they arise.

## RESIDENTIAL PROPERTY: THE LEGACY OF DEBT . . .

Here we examine the likely direction for an asset dear to most of our hearts – residential property. Many of the statistics used relate to the UK market and so cannot always be assumed as applicable to where our readers reside.



That said, we have tried where possible to discuss themes that are common to many private property markets throughout the world.

### A reminder of the Noughties . . .

- From 2000 to 2009 the average UK home rose in price by 67% post inflation, the fastest growth rate seen in the last 50 years.
- There was a significant ripple effect outside the South East of England. Pembrokeshire and Cornwall topped the price growth league for the decade at over 200% each.
- The buy to let investor created an extra 1.3 million private rented homes between 1989 and 2009.
- Intense mortgage competition and appetite for home ownership led to outstanding mortgage loans reaching £1.226 trillion in 2009 compared with £256 billion in 1989, a rise of 479%, whilst real household incomes over the same period barely advanced.
- The rise of the international investor and owner. No longer was it just London infused with foreign money, as many provincial markets saw the impact too.

### What's happened recently . . . ?

- Much to the chagrin of those spoilt by abnormal conditions, signs of a nicely balanced housing market are returning.
- 2009 saw very modest, possibly sustainable UK wide price growth after the worst falls in 2008 seen since World War Two. Buyers are factoring in sensible growth expectations which should always be simply the rate of prevailing inflation. Clearly, any further growth that arrives is a bonus that should never be budgeted for, or worse, borrowed against.
- New UK buy to let mortgages in the 3rd quarter of 2009 dropped to 14,500 from 48,700 two years before.
- Between 2005 and 2007 around 525,000 UK house transactions took place each year. This fell to around 300,000 in 2009.
- Average property values are some 12% below their 2007 peak levels.

## So what's coming next . . . ?

- Volatility. Many people's impression is that bricks and mortar offer steady progression. In fact nothing could be further from the truth. If we all valued our houses every month as we might our investment portfolios we would receive quite a shock! This volatility will grow considerably in tandem with our desire to be informed about the value of our prime asset. There is no reason to be concerned and in many ways blind optimism by amateurs that property always goes up will be tempered by better information flows.
- Throughout the country, the current stock of new build and older homes for rent will actually meet the ever growing market demand (see paragraph below). However, we do not need an ever increasing supply of new landlords and in many areas there are already far too many.
- We see no change to the rather peculiar English psyche that desires home ownership. However the return to old style mortgage lending criteria, job insecurity and interest rate rises will mean that non-shared ownership will be an unattainable dream for most average wage earners. This will hold back demand for areas with high density of low value housing and will prevent much of the speculative development we became used to in the noughties. Ultimately the real price of the average UK house will have to regress until the point where real incomes have caught up such that a couple can re-enter the housing market with a 10% deposit and a normal multiple of 2.5 to 3 times their joint income. In the South East of England even the average house price is still 25-33% too expensive for the average income family to afford in the modern financial era.
- Banks will compete for mortgage business more than they are doing so today. However it will be more than five years until they have forgotten the damage caused last time and start reckless lending again. Rest assured, they will make the same mistakes again. Why – shareholder pressure for profit is one reason. In our opinion banks shouldn't be public companies.
- Those prime residential markets dominated by high earners, more equity, easy travel logistics and the international ripple effect will continue to advance ahead of the broader market. Further helping hands will be ever tougher planning restrictions, hard to get into schools and demand-supply imbalances in favoured areas. However, overall growth in this prime market will be restrained over the next 10 years as this market has shown itself to be much more susceptible to seismic events than previously thought. In addition owners will be targeted by government revenue raising initiatives, such as the increase in a UK property transfer tax called Stamp Duty Land Tax from April 2011.
- Much has been written about London's super prime market, perhaps characterised by property for sale in excess of £10m. Suffice to say mega flats and houses will still sell particularly to those holding a much stronger currency than GBP. However, beware the hype in terms of the prices paid. Billionaires don't become billionaires by paying top price . . .
- The bank of Mum & Dad has become a much needed support for the entry level property market. However, this 'bank' relies on its own 'chain' of needing substantial equity in the family home. As this equity is eroded in real or notional terms the next generation of buyers cannot rely upon parental support in the way it has.
- In summary, we are seeing a swift return to a 'normal' demand/supply led residential property market. The added aspect is the available supply of mortgage finance itself – a notion new to property buyers under the age of 30!

## RISK WARNING

Investors and their advisers should be aware that the value of investments and the income from them may fall as well as rise and an investor may not get back the amount originally invested. Past investment performance is definitely not an indication of future performance. Depending upon the investor's currency of reference (viz. the currency in which they are used to working), currency fluctuations may adversely affect the value of investments and the income from them. Any forecasts or opinions are SCD&Co's own at the date of this document and may change. Those forecasts should not be regarded as a guarantee of future performance and readers are expected to take appropriate and reasonable advice before taking any investment action. SCD&Co is not authorised to give financial advice on the best way of structuring investments from an income, capital gains or inheritance tax mitigation perspective, nor on the most appropriate trust and other structures to achieve the best outcome, and investors should therefore consult their usual financial adviser, accountant or other appropriate professional before proceeding with an investment.