Investment Strategy for the Credit Crunch!

Stock markets are faltering worldwide, with oil and gold prices at record levels and the pound and dollar in the doldrums, partly due to a banking crisis that arose out of risky loans on property. The spectre of inflation looms after a period of easy money, as everything from food and petrol, to mortgages and electricity gets dearer.

Onerous taxation is making the Labour government unpopular, whilst there is a lame duck Republican president in the US, fighting an unwinnable war. If that sounds like today's situation for investors, it was the same scenario between 1972 and early 1975 when London saw the worst bear market so far!

Over the last few months stock markets around the world have suffered increased volatility, with the UK FTSE All Share (ex Investment Trusts) falling over 21% (at the time of writing, 3rd July 2008) from its high in 2007.

It's not surprising therefore, to hear comments such as 'Markets are uncertain' and journalists and other 'experts' questioning whether capitalism as we know it will cease. Markets are driven by news and such news is random.

Notwithstanding the current problems relating to the credit crunch, stock markets are always uncertain, otherwise there would be no return premium for owning equities and we would all own government bonds or cash. In addition, while seeing the value of one's capital fall and rise wildly can be emotionally uncomfortable in the short term, inflation is arguably the greater threat to long term financial security and freedom of choice.

Short term forecasting of what will happen to different asset classes is a fool's errand and of no benefit to the smarter investor. Whenever annual investment returns from equities depart materially from the long term norm this is not usually due to the economies of investing in the earnings growth and the dividend yield of companies. Earnings growth has been positive in every moving decade since the 1930s and dividends are always a bonus, not a given. Stock market returns are volatile because of the emotions of the investors and the willingness to pay a higher or lower multiple for earnings from companies. The price/earnings ratio (P/E) reflects the savings in investor emotions ranging from greed (high P/Es) to hope (moderate P/Es) to fear (very low P/Es).

Because the bulk of returns from stock markets are based on earnings and dividends, the market has a positive sloping return expectation and in broad terms there is a 3 out of 4 chance of returns being positive in any given year. Therefore forecasting long term returns, rather than short term investor sentiment, is actually a much more achievable task. Benjamin Graham, the eminent American investor once said, "In the short term the stock market is a voting machine… but in the long run it is a weighing machine".

When looking at your investments and deciding whether to invest, remain invested or encash, there is often a big danger in following the market:

- Money tends to be invested when markets are strong and prices high
- Opportunities could be missed when prices are low
- There is more growth potential by buying when others are selling and holding on to the investments for the long term

Investors pulled a net £156million out of equity funds last month (whilst investing £366million into bonds), generally a sign we may be close to a turning point.

Taking resource stocks out of the equation (oil/mining etc) we have been in a bear market for some time – so we are probably some way through that cycle, from which we could be emerging within the next 12 months (most bear markets last about a year to 18 months on the outside).

It's human nature to follow the herd and of course it's better to get in near the bottom of the market than the top; there's evidence to suggest now may be an opportune time to invest.

Trying to time any market is a pastime that can seriously damage your wealth. One way to look at this is if you had remained fully invested from September 2002 to June 2008; the FTSE All share would have returned 63.4%, but missing the best 10 days reduced that return to 40%, and missing the best 40 days to only 3.9%!!

It is time in the market, not timing the market, which is important. The market moves fast and your annual return can come from just a few days of big moves. No one knows which days those will be.

If you would like to discuss this in more detail, please contact:

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