MARKET BULLETIN

ST. JAMES'S PLACE
WEALTH MANAGEMENT

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Over and Out

On initial reflection, 2011 may appear to have been a year to forget for investors. Many global equity markets suffered a difficult time as the world became a forced spectator to the eurozone sovereign debt crisis. As European leaders went from one economic summit to the next, they announced a string of ill-considered proposals to solve the crisis, which sapped confidence and left investors bewildered. Fortunately, the markets finally lost patience with the politicians and took matters into their own hands, with vigilante investors forcing up the cost of borrowing for the eurozone's most profligate states, which in turn forced EU leaders to get to grips with events. Not that the crisis is over, but at least some progress has been made; although it has been an uphill battle for investors, manifesting itself in wild swings of volatility. So it's no surprise that the year ended leaving investors suffering from what might be described as 'crisis fatigue'. Sifting through the financial debris, though, throws up some very mixed, and in some cases unexpected, outcomes.

Unsurprisingly, the place not to have been was in European equities, with the major bourses falling, by around 15% in Germany's case, to 25% in Italy. Despite their robust economies, emerging markets', and particularly Asian, indices fell by around a fifth. Here in the UK we fared better, with the FTSE 100 slipping just over 5% but only 2% after dividends are reinvested. The surprising winner – despite its credit-rating being downgraded – was the US where the super blue-chip Dow Jones Industrial index actually ended the year 6% higher. Away from equities, investors sought out not just gold but also the perceived safety of US Treasuries, UK gilts and German Bunds; the yields of which all fell to near-historic lows. The inverse relationship between yields and capital values meant that as investors piled into government bonds, capital values rose and yields fell to below 2%. UK commercial property quietly moved ahead, with the broad-based IPD index yielding around 6.5%; whilst in London, prime residential property lived in a world of its own with prices forced higher on the back of foreign demand. For those investors who had a balanced and diverse portfolio of quality assets, though, the overall outcome for 2011 was probably better than many expected and in some cases, positively so.

Welcome to 2012

The big question for investors is 'what will happen this year?' If you are hesitant about forecasting or just don't have a clue, don't worry, you're in good company. After their drubbing last year, most analysts are being coy about where the FTSE 100 might end this year, citing volatile markets as the reason for their uncertainty. Over at the Bank of England (BoE), its governor Sir Mervyn King was candid enough to say "Who knows what is going to happen tomorrow, let alone next month?" But it might be helpful to think about the issues that might influence the markets and then think about investment strategies that could help mitigate the inevitable risks associated with investing.

Here's a flavour of some of the questions economists have been mulling over. *Will the eurozone survive intact*? Mixed views here but the weight of opinion seems to be that Greece will ignominiously exit the club within the next year. *Will the sovereign debt crisis hit Britain?* Possibly but unlikely, even though growth has flatlined; the markets have been impressed with the government's resolve to continue with its austerity plan. The BoE might even help out with some more quantitative easing following its recent decision to implement a second

round of QE amounting to £75 billion. *Will the 30-year bull market in government bonds come to an end?* The consensus is that this appears unlikely in the immediate future given eurozone uncertainty, even though they have become undeniably expensive. *Will US and UK companies pay out higher dividends?* Almost certainly, it appears, as companies have substantial free cash flow and little appetite to embark on acquisition sprees.

In terms of strategy, the best course of action would be to create a portfolio that will respond in a similar way if the markets deliver 'more of the same' this coming year; in other words, a strategy that would have done well last year and is positioned to repeat it again this year. Such a strategy would have six key components. 1. It would be diverse at an asset class level by holding a mix of cash, fixed interest, property and equities. 2.There would be a focus on income, including fixed interest and dividends – even if these are to be reinvested – with the latter offering an element of protection from inflation. 3. Exposure to large companies would most likely produce better outcomes as this sector is, according to research by Morgan Stanley, trading at materially lower valuations. 4. Within the equity part, an emphasis towards more defensive stocks such as healthcare would, given the economic backdrop, offer greater protection. 5. Given the predicted economic slowdown on the Continent, companies that generate the majority of their income from abroad but outside the EU are likely to fare better. Research by UBS suggests that 54% of revenues generated by FTSE 100 companies comes from outside the UK.

Lastly, whilst emerging markets disappointed on the downside last year, their long-term prospects are better than most developed economies. Research from Goldman Sachs concludes that the BRIC countries – Brazil (which overtook the UK in 2011 to become the world's 6th largest economy), Russia, India and China – are likely to contribute 72% of global economic growth during the coming year. Because of the extra risks associated with direct investment in the emerging world economies, often the best way into these areas is through stocks with global exposure. So, whilst offering no guarantee of success, this type of approach for creating a truly diversified global portfolio can at least offer a greater degree of certainty in what remains a very uncertain world.

A Professional Investor's View

Markets dislike the uncertainty which is set to prevail entering 2012. Many commentators 'called' 2011 incorrectly, highlighting the difficulty of forecasting markets in the short term and the importance of retaining focus on long-term outcomes and objectives.

One fund manager who has focussed on the long term for over 30 years is William Browne of Tweedy, Browne Company, LLC who manages part of the St. James's Place Global Equity funds. When asked about the current positioning of his portfolio, he outlined exactly this strategy. "These seemingly insurmountable macroeconomic concerns have spawned a level of market volatility that is unnerving for even the most resolute of investors. We are sensitive to the fact that equity market volatility can be devastating for those who frequently need access to their capital. However, for those with more patient capital, markets such as these can produce rare pricing opportunities that over longer measurement periods could prove to be quite advantageous. Our focus today continues to be on larger, less cyclical, undervalued, steadier dividend-paying companies with more sustainable demand characteristics that are globally diversified, have solid balance sheets, sell products to an aspiring and growing middle class, and pay an attractive yield. These are the kinds of businesses that should be able to withstand significant adversity, and over time come out the other side stronger and more valuable."

In the UK, Neil Woodford of Invesco Perpetual, manager of the St. James's Place UK High Income fund, continues to stick to his long-term philosophy and does not worry unduly about what might happen over the short-term perspective of the next calendar year. "We maintain our view that there are certain types of companies that can thrive, delivering sustainable dividends and earnings growth, in this environment. Indeed the underlying performance of the businesses we are invested in has been as good as, if not better than, we had expected, despite all of the very difficult headwinds we have seen. Much of what has caused the recent

stock market volatility has centred on weak economic growth projections and the ongoing sovereign debt crisis. We reiterate our view that this is not new or a surprise to us. We remain disciplined, patient and long-term investors. The stock market volatility has presented us with attractive opportunities to invest for the long term, in companies which are capable of delivering attractive returns despite the economic turmoil."

Even in European markets, opportunities present themselves when taking a longer-term view and analysing companies on fundamentals rather than macroeconomic concerns. Stuart Mitchell of S. W. Mitchell Capital, manager of the St. James's Place Continental European funds, commented, "The outlook for the European company sector still appears positive. We have met with over 300 companies since the 'crisis' broke in July. Virtually none of the management teams we have spoken to have seen much sign of a slowdown in business activity. Furthermore, European companies have worked hard to cut costs and improve balance-sheet strength following the bankruptcy of Lehman Brothers. For the time being, we have continued to focus our investment efforts on high-quality growth companies best able to develop their businesses despite operating within a sluggish economic environment."

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