The Red House

The Red House Client Bulletin

"Be greedy when others are fearful and fearful when others are greedy"

Warren Buffett's famous quote on how to invest successfully really ran true over the holiday period. The fear factor was certainly there with headline news in the weekend FT with the UK Unit Trust industry reporting that they had more client money exiting their funds than investing in November. The last time this happened was in 1992, but we also saw significant disinvestment from equity unit trusts more recently in 2002 and 2003. This is compared to periods of high investment when markets were rising such as at the end of the last century and in 2005/2006. Sadly this is entirely the wrong way round as investors are buying at the peak of the market when the equity prices are at their highest and selling in the troughs when the prices are low. Trying to time the equity markets is more akin to speculation than investment, seeking quick returns by betting on short term market movements. As our recent client presentations have shown there are going to be times when different equity markets will perform adversely compared to others. Between 2003 and 2006 UK equities was pretty much the place to be but in 2007 the reverse is true with emerging markets the best performing asset class.

And who was greedy over Christmas? Warren Buffett went shopping on Christmas Day and spent US$4.5billion on an industrial conglomerate called Marmon, and then another US$441million on the NRG Reinsurance Company. Now it might be said that Mr Buffett is contradicting our theories on stock picking. Far from it. He is recognised for his long term buy and hold strategy. His Berkeley Hathaway fund is large enough to carry out asset class investing by acquiring whole companies. The latest purchases look very much like value companies at the time when the market seems to feel that these are out of favour. Mr Buffett said on CNBC that Marmon was "our kind of company...it's in some very basic businesses but good businesses...The test will not be whether the stock market likes it today or tomorrow, the test will be where it is in 10 years...This is a large bet on America over a long period of time."

Financial fortune telling

The FT Money section had a two page spread where leading fund managers and economists gave their prediction for where the FTSE100 Index might be at the end of 2008. These ranged from 7,200 to 5,850. The Index at the end of the year was around 6,450 so the predictions varied from +11.5% to -9.5%.

One wonders why they persist with this nonsense. I noticed they didn't mention the previous year's forecasts. I'll keep this edition and let you know in 12 months time how they did.

This sort of reporting can only confuse the DIY investor and probably put them off from investing in equities at all, when all the long term data shows that obtaining the risk premium from equity investment will outperform the other major asset classes of cash, bonds, and property.

One year is also not a sensible period for any equity investor to consider. It would have been more useful if these experts could tell us where the equity markets are likely to be in 5 years time which is the minimum period we would usually consider for equity investing. Of course they will not do that, as their widely varying 12 month forecasts are based on short term indicators such as interest rates, the credit crunch and the various political crises that impact in the short term. This is very much the information that somebody wishing to make a bet on the market needs but is not of much use to the long term investor. The only prediction TRH would make is that over periods of 5 years and longer a diversified portfolio of equities is likely to produce a better return than cash or bonds.

Another nonsense is using the FTSE100 Index to assist investor's decision making. This index is biased towards large and growth companies as opposed to value and small companies. A long term investor should have a diversified portfolio that will capture a wide range of equity asset classes including large, small, value, domestic, overseas, and emerging markets. We fully expect these different equity asset classes to produce different returns from one year to the next and in comparison to each other.

The Red House Investment service

When setting up TRH, Ruth and I were keen to develop alternative methods to assist our clients in their financial planning. One of the most important was the introduction of long term asset class investing using institutional fund managers. We have been pleased with the response we have had to the detailed presentations we have given to a number of clients. The first portfolios have now been established, with others in the pipeline.

We have developed TRH Investment service on the following principles:

- Equity markets are efficient. We do not believe that consistent market outperformance can be achieved by stock picking, active management or timing markets. Achieving the long term market returns are what our clients require from their portfolio.

- The different equity asset classes – large, small, value, growth, domestic, overseas, and emerging markets will produce differing returns from one year to another and in comparison to each other. They will also exhibit different risk characteristics.

- Clients who have seen our presentations will realise these investment principles are based on extensive research and masses of data that analyses the past performance of the major asset classes. This research shows the following consistent themes over long term periods.
  - Equities outperform bonds and cash.
  - Small companies outperform large companies.
  - Value companies outperform growth companies.

- There is a risk in investing in equities and further risk dimensions are added by utilising the small and value companies. Our clients therefore deserve the risk premium from investing in these asset classes and we believe that risk premium is best obtained by a long term buy and hold strategy.

- We have built a range of diversified portfolios using these asset classes together with global short term bonds to match our clients' tolerance for risk and their investment horizons. We monitor these portfolios and rebalance when appropriate to maintain the agreed asset allocation.

Client communication

We like to think that we are creating a different type of advisor for the select group we are proud to have as our clients. Part of that difference is our availability to discuss any financial questions or concerns that you might have. Therefore please do not hesitate to contact Ruth or me if this note provokes any thoughts you would like to discuss, or indeed if there are any other financial matters you would like to talk to us about.

Happy New Year

Gareth Marr and all at The Red House

7th January 2008

A regulatory note