Sector Analysis - Quarter 1, 2012

ifs **Financial** Management

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An Overview

At IFS we continue to hold serious concerns for the year ahead, which in turn compels us to recommend that clients maintain a more cautious approach for the foreseeable future!

We have two areas of particular concern;

An obvious threat is the Euro-zone / banking crisis, which has far from abated.

On a more tactical level, we are also concerned about the value of UK government gilts, which is of particular relevance, as they typically form such a large element of our core portfolios.

More generally, we are recommending the following:

- Clients go underweight in gilts and instead switch a higher percentage of their portfolios into higher-grade corporate bonds, which are providing more attractive yields, with lower downside risks.
- That where clients do opt to hold gilts [most typically this would be the more cautious investor] they favour index-linked gilts over fixed interest gilts, as inflation will persist for the foreseeable future.
- To our mind commercial property remains an asset to hold, as the income yield is holding somewhat steady [at around 3.20%], whilst prices remain depressed - and hence there is less risk for a large downward correction.
- For those who are more patient, we are recommending they go underweight in shares, and hold back money in “cash” funds, so that they can exploit any market correction - i.e. hold cash so that there are funds ready to go back in on the cheap, should the Euro implode.
- For those who are more inclined to buy and hold over the longer term, we recommend that they switch any shares into “equity income” holdings; the rational being that even if the stock market remains static, the higher dividends will boost returns through compounding.
- Due to all that is going on in the world, we continue to recommend that clients avoid generic investments in overseas shares (due to the very volatile nature of currency risks, which could easily wipe out any gains if decisions are taken casually). Indeed, for those clients seeking investments overseas, we continue to advise on an entirely bespoke basis, with the specific fund recommendations being researched by our in-house expert, Mark Potter.

Risks on the downside

To our mind the Euro-zone crisis is far from over, and if the currency goes, we expect world stock markets to follow.

Whilst Greece looks like a very real default risk, our more pressing concern is that Italy will struggle to repay its debt.

Indeed, Italy raised less than its maximum target at an auction on Dec. 29, even after the European Central Bank provided banks with a record 489 billion Euros ($635 billion) of three-year loans. Italy's 10-year bond yields are above 7 percent, a level those economists predict is unsustainable.

This does not bode well for the future, and calls into question whether the Euro will survive – The Euro members can bail out a small economy like Greece, but probably not one the size of Italy.

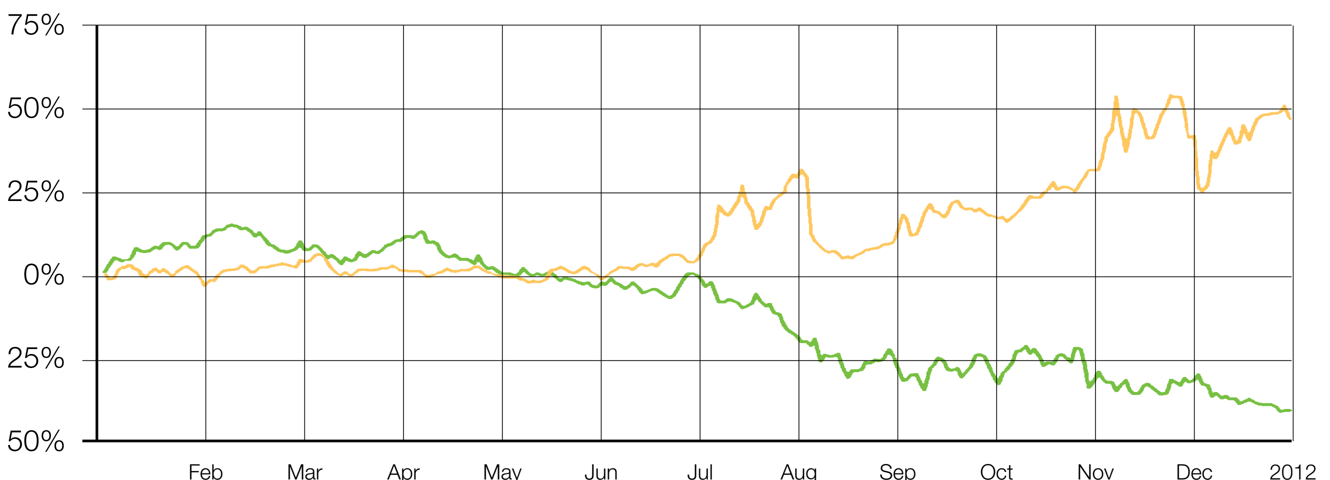
Conversely, these fears have caused a flight to safety, which has boosted demand for gilts, pushing prices to high levels; Gilts returned 17% in 2011.

However, whilst this has been good news for gilt holders to date, we now face a far higher [than normal] risk that gilts will fall back in time. So to our mind, now is an excellent time to sell gilts to secure recent profits, especially as yields on gilts are at an all time low.

These two issues are illustrated perfectly below.

The top line in the graph shows the interest rate that the market is demanding to lend to Italy - a rate that the Italians simply cannot afford for long.

The bottom line shows just how far gilt yields have fallen of late; to our mind this now makes them far less attractive to hold, relative to corporate bonds.



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Corporate Bonds Vs Gilts

Corporate Bonds are loans to companies over a fixed-time period, and there are in essence two main types - Investment Grade or Non-Investment grade.

"Investment Grade" bonds are loans to more secure companies, where it is forecast there is a good chance that the investor will get their money back.

It is interesting to note that, whilst investment grade corporate bonds would typically be considered slightly more risky than gilts, over the last year or so gilts have actually become more volatile.

Furthermore, as we have mentioned above, gilts prices have risen drastically over the last year or so, and so have further to fall back to par.

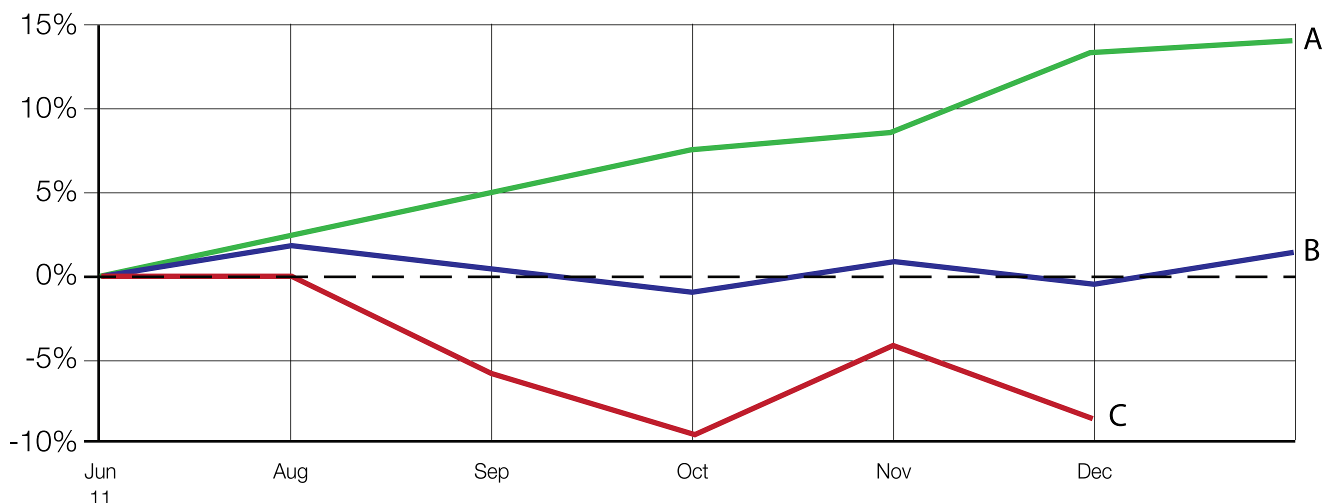
The rise in gilt prices can be linked to two main issues

The Eurozone / banking crisis has compelled investors to seek cover, and they've chosen UK gilts, thus boosting demand and prices.

The UK government, through "Quantitative Easing" (i.e. where they effectively print lots of cash, which they lend to themselves) have caused an even bigger surge in short-term demand for gilts.

Having a somewhat contrarian approach, we would therefore recommend that

- clients sell gilts to secure profits (see the higher GREEN line A)
- Move more cash into the higher-grade corporate bonds, which appear at present to be more secure (see the BLUE line B).



A - IMA GM TR in GB (14.23%)
B - IMA Sterling Corporate Bond TR in GB (1.45%)
C - IMA Sterling High Yield TR in GB (-8.86%)

12/06/2011 - 12/12/2011 Data from FE 2012

Non-Investment Grade Bonds

Non-Investment Grade bonds are loans to companies at the riskier end of the spectrum; becuase of this they are often referred to as "Junk" bonds.

These, whilst offering a higher interest payment, can be considered far less secure than either gilts or investment grade corporate bonds.

However, for those investors seeking a regular income yield, this isn't to say that higher-yield bonds should be ignored completely.

It should be noted that higher yield corporate bonds have a negative correlation to gilts. Therefore, they offer protection against a fall in gilt values.

The table below shows the correlation between High Yield Corporate bonds and gilts.

How prices of Higher Yield Bonds react to:

Corporate Bond	0.58
Gilt	**-0.46**
Index Linked Gilt	**-0.30**

Note: A figure of +1 shows perfect correlation (in other words prices move perfectly in line with each other). A figure of ***-1*** *indicates that prices would go in exactly the opposite direction.*

It is therefore worth noting that if gilts drop in price, higher-yield corporate bonds would go up by around half as much. Therefore, if you held a 2:1 ratio of gilts [to higher-yield corporate bonds], you'd achieve optimal diversification – any losses on one sector would be offset by gains on the other. *Indeed, this relationship can be seen in the previous graph – compare line A to line C.*

For this reason, we would suggest that those with a "buy & hold" strategy would be advised to mix corporate bonds, higher-yield bonds & gilts into their portfolios to gain better overall diversification.

However, it must be stressed that higher yield corporate bonds are more risky. Indeed, the theoretical downside on higher-yield funds is approximately four times higher than on gilts.

Therefore, whilst the yields are certainly attractive, we would advise against going overweight in higher yielding corporate bonds.

However, for those who are prepared to take more risks, higher-yield bonds should not be ignored. Indeed, our four chosen High-Yield bond funds are producing an excellent income yield, currently 7.03%. And in a period when investors are suffering from very high inflation, perhaps this extra yield merits the risks.

Shares

As the graph below demonstrates, UK shares (the purple line B) have certainly been far more volatile over a 5-year period than have been corporate bonds, whilst producing lower returns.

Nonetheless, we still feel that there are compelling reasons to hold shares.

- Our four chosen “Equity Income” funds are currently producing a weighted income yield of around 4.2%.

- Over 10-years, the FTSE 100 has traded at a price/earnings ratio of around 16-17; today that ratio is nearer 10, making them seem cheap.

But it should be stressed that we are in a period where companies are deleveraging (paying back loans) which will depress dividend returns, whilst shares are suffering from significant volatility, and so timing is important.

To hold or not?

Generally speaking, we maintain a normal UK share weighting in our “passive” portfolios, as we feel that the dividend yield remains attractive.

However, for those clients who subscribe to our “managed portfolio service”, we are suggesting a slightly more active stance.

- We have built a portfolio that we are recommending whilst the FTSE 100 trades between the 5750 & 5000 levels, and here we have moved the shares into cash.

- We have a second portfolio that we will recommend to clients should the FTSE 100 go near or below the 5000 mark – here we’ll move the cash back into shares, hoping to profit by buying on the cheap

A - IMA Sterling Corporate Bond TR in GB (16.42%)
B - FTSE 100 TR in GB (8.87%)

12/01/2007 - 13/01/2012 Data from FE 2012

Property

At IFS we maintain the view that Property holdings should be maintained within all of our core portfolios

- Our four chosen property funds are currently yielding 3.2%
- Over three years property prices have been a half as volatile as gilts
- Over three years property has been four-and-a-half times less volatile than shares.

Indeed, as illustrated in the graph below, property (B) has produced a steady return over three years, with considerably less volatility than shares (A).

It should also be noted that, whilst property displays far less volatility than seen with shares, the overall correlation of price movements is nearly perfectly aligned, which also means that property is also negatively correlated to gilts.

Therefore, property offers an excellent way to add positive diversification to a portfolio holding gilts, and allows the investor to produce a comparable yield to shares, with substantially lower volatility.

In short, in these high-risk times, property is an excellent hedging tool.

How prices of Commercial Property react to:

UK Shares	0.95 (1.0 is perfect correlation)
Gilts	**-0.16**
Corporate Bonds	**0.51**

Some basic Statistics for consideration

As we noted at the start, the team at IFS remain somewhat gloomy about the prospects for world growth over the next year or so.

Here are some sobering figures that support this position.

- CPI annual inflation stands at 4.8 per cent.
- RPI annual inflation stands at 5.2 per cent
- The unemployment rate was 8.3 per cent of the economically active population, up 0.4 on the quarter, meaning that there were 2.64 million unemployed people.
- The unemployment rate is the highest since 1996 and the number of unemployed people is the highest since 1994. The inactivity rate for those aged from 16 to 64 was 23.2 per cent, down 0.1 on the quarter. There were 9.33 million economically inactive people aged from 16 to 64.
- Total pay (including bonuses) rose by 2.0 per cent on a year earlier, down 0.3 on the three months to September 2011(with both the private and public sectors showing lower pay growth).
- UK gross domestic product (GDP) in volume terms increased by 0.6 per cent in the third quarter of 2011
- Public Sector Net Borrowing excluding financial interventions £18.1 billion (November 2011) this is £2.3 billion lower than in November 2010.
- Net debt excluding the temporary effects of financial interventions was £977.1 billion, equivalent to 62.8 per cent of GDP. This compares to £853.9 billion at the end of November 2010 (Monthly).

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