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WARWICK BUTCHART ASSOCIATES

Warwick Butchart Associates Ltd
Independent Investment and Financial Advisers
45 Portland Street, Cheltenham, Gloucestershire GL52 2NX
Tel: 01242 584144
Email: help@warwickbutchart.co.uk Web: www.warwickbutchart.co.uk

Your independent window on financial issues

Time for a considered view

During the past week or so, a number of circumstances have conspired to cause panic in stock markets across the world. This is no time to put one's head in the sand and ignore what is going on, but it is equally not a time for blind panic which is, quite literally in some cases, what appears to be happening.

It would be absurd to ignore the fact that poor economic data has caused concern over the prospect of a return to recession in the UK as well as elsewhere. It is important to note, however, that the impact of very real fears has sent stock markets into a form of freefall that owes as much to the existence of 'stop-loss' arrangements as mature consideration. Stop-loss arrangements are systems that automatically trigger a computer sale (hence "blind panic") under certain conditions such as a set percentage fall in the value of a share or sector. When shares start to slide due to the actions of some major traders, this can turn into a cascade simply because computers – or more properly, the rules and programs that govern their actions – demand it.

The usual roller-coaster ride?

In other words, the economic and political conditions that gave rise to market nervousness have started a slide that only human intervention – and that from people who really understand what is going on – can reverse. History tells us that this will be the case; look at any chart of stock market performance and reversals are inevitably followed by a period of subsequent growth, although it must be said that we appear to have hit more reversals than usual since the start of the millennium.

Politics is one key…

The underlying causes of the current crisis of confidence are largely political. For too long, governments in many parts of the world have spent more than they earn and have therefore had to borrow in order to balance their books. This is nothing new, as any historian can tell you. What is different this time is that, backed by high levels of personal spending and borrowing in the developed economies, some of us have become accustomed to a high standard of living that depends on more and more government spending and less taxation.

Will we all be contaminated?

When governments ***have*** suddenly come to their senses – largely due to the credit crunch – there has been considerable resistance from various sectors of the population to the idea of less welfare spending and higher taxes.

- In Italy and Spain people regularly demonstrate and riot against spending cuts – precipitating the euro crisis that will be difficult to resolve;
- In the US, the Tea Party prevents the administration from increasing taxes as it needs to – leading directly to a loss of the nation's AAA rating; and
- In the UK, opposition politicians object to tax increases and spending cuts (the latter of which they had proposed to make anyway)

Some may argue that politicians are no more than spectators when it comes to economic conditions such as these; but without coherent and decisive action, recovery will be a long time coming.

…Confidence is another

There is, however, another strand to any potential recovery. Investors need to understand that their actions could actually help stem the slide and start the recovery. On the 9th August, the FTSE100 stood some 20% below its long-term trend since April 1984. It would be a brave commentator who suggests that there will be no recovery, as we have seen so often before. Conversely, there is no reason to suggest that this will happen quickly without some form of positive action. This could come from investors themselves understanding that to sell on a falling market is simply one way of losing money.

Of course, as we saw with the banking crisis, there is sometimes no alternative but to offload shares that have no hope of recovering. But in general, provided the underlying conditions are right – and many of our leading businesses actually came through the recession in remarkably good financial condition – holding shares in the expectation of a recovery can save dealing costs; not to mention a lot of anguish over timing.

Markets are well below long term trend

A route to economic recovery

In the UK, we can only retain our (now more valuable than ever) AAA rating if we follow the cost cutting exercise that will allow us to reduce government spending. However, economic growth is essential if tax revenues are not to collapse and be accompanied by increased welfare spending on unemployment benefits.

We must export more

This means that we must find ways of exporting into a potentially shrinking market, should the US and Europe suffer further economic reversals. It is not a question of a much demanded 'Plan B' but rather focusing on exports as a way of generating more real (full time) jobs to replace those necessarily lost in the public sector, as well as avoiding costly and ultimately pointless strikes in the public sector that can only slow the recovery.

Actions for investors

Warren Buffett famously built up his vast fortune by investing in a 'contrarian' manner; in simple terms, he bought when others were selling and sold when they were buying. This is not something that individual investors can easily emulate, but it does point out the dangers of following the herd. For most of us, taking a long-term view of our investments is the only practical way of behaving. If we seek to readjust our holdings too frequently, we increase our dealing costs and then have to make new decisions on a regular basis; something that few of us have sufficient time to do.

By investing in collective investment vehicles such as unit trusts, individuals can benefit from professional investment expertise and avoid individual costs of trading (these are included in the unit prices). It is not enough, however, simply to set up an investment on a single- or regular-contributions basis and then forget about it.

Regular reviews are essential

In investments, as in life generally, things change and it is essential to monitor holdings regularly to ensure that they remain consistent with overall investment objectives – and risk tolerance – as well as to ensure that they individually perform in line with expectations. Allowing your independent financial adviser to undertake regular reviews is probably far more important than reacting to short-term market fluctuations, because these reviews will take market movements into account.

Ultimately, buying or selling individual shares or units in a collective investment will be something for each investor to consider, based on personal advice. In the broader context, ensuring that you have the right balance of assets is probably more important than thinking about individual shares; a spread of assets, such as a portfolio of funds, is more likely to give you a greater protection against loss.

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