

### Live long and prosper

I hope that readers will be familiar with the character of Mr Spock, Starfleet's first officer on the bridge of the USS Enterprise in the hit TV series Star Trek. As any "Trekkie" will tell you, Mr Spock, with his pointy ears, pudding bowl haircut and split fingered salute originated from the planet Vulcan. As the story goes his father was a Vulcan but his mother was one of us, a human. The trademark of this fictional character was his logical perspective and a remarkable detachment from human emotions, such as fear and greed. With these attributes Spock would certainly make a *STAR* fund manager.



It is often said that the financial markets are driven by logic over the long term but by human emotion in the short term. Indeed to quote Benjamin Graham, considered to be the first proponent of value investing, "the owner of equity stocks should regard them first and foremost as conferring part ownership of a business. With that perspective in mind, the stock owner should not be too concerned with erratic fluctuations in stock prices, since in the short term the stock market behaves like a voting machine, but in the long term it acts like a weighing machine."

Graham believed that true value in the long term would be reflected in the share price. But fear and greed can push prices to extremes in either direction in the short term. Typically market commentators justify these short term fluctuations with fundamental economic analysis. However, the truth is that more often than not, short term fluctuations are driven by there being more buyers than sellers, or vice versa all acting on a tide of human emotion. This can often lead investors to make rash decisions that can result in mistakes and portfolio losses.

A study of financial market history suggests that prices will tend to move in long term trends, more commonly referred to as bull and bear markets. With access to long term data these trends can easily be identified; over time we can essentially drawn straight trend lines from trough to peak or from peak to trough. But as we know markets do not rise or fall in straight lines. Instead they will fluctuate around their trend lines or “fair value,” driven by human emotion. When prices become detached from their fair value and shares are either over bought or oversold, market participants look to pull them back into line. This process is referred to as mean reversion.

Mean reversion is one of the most powerful forces in investment management. Markets are in essence like a pendulum, they will swing backwards and forwards at varying speeds but will in the end revert back to the centre. The theory sounds fine in principle but in practice investors need to establish where their mean lies before they can profit from a reversion to it. Share prices could look cheap relative to the mean of the last decade but expensive compared to the mean of the last fifty years. The process of mean reversion can be applied to share prices within an asset class and can also be used to evaluate the relative attractions of one asset class over another, for example bonds versus equities.



So where are we today? The equity markets have been trending upwards over the last eight months, a dramatic switch from the downward trend we witnessed previous to that. The current trend is driven by the actions of governments and their central banks that have been willing to do whatever it takes to reflate the economy and fight deflation. Their actions have been unprecedented. We have seen extremely low interest rates and a massive amount of quantitative easing. Short term this kind of shock treatment has been constructive for asset prices, but there is a fear that these policies may be destructive in the long run. Already there is talk of the next bubble being created in a similar fashion to the Tech, Housing and Credit bubbles of the last decade.

Over a period of time history teaches us that nearly all changes of trend are preceded by a change in monetary policy, whether that be easing or tightening. A bull market has usually been preceded by a slashing of interest rates and a bear market by a hike in interest rates. It is important to note that there is always a time lag for policy to take effect. The end of the Tech bubble was brought about as central banks drained excess liquidity from the markets as fears of Y2K abated. Whereas the additional liquidity and cutting of interest rates post 9/11 triggered a bull market in 2003 which lasted until late October 2007. Interestingly, the first hike in UK base rates was in October 2003 with further gradual rises over the next four years as the Bank of England looked to slowly drain liquidity from the economy. Eventually this policy of slowly withdrawing liquidity

led initially to a housing bubble, then a credit bubble, and finally the recent crisis which threatened the very fabric of capitalism.

Policy today is extremely easy with record low interest rates and the authorities in the major developed economies prepared to print more money if required. This side of a General Election in the UK I would not expect to see a change in a policy. A policy which is looking to reflate the economy, create jobs and grow the economy. Despite the fact that the recent economic growth numbers showed that the UK remained in a recession, I would expect to see official confirmation of a recovery in the near future. This was a major blow for the government, especially when there are signs of recovery elsewhere in the world.

There is no sign today that either of the two central banks at the heart of the global credit crisis, the US and UK, are considering monetary tightening. Indeed Ben Bernanke, Chairman of US Federal Reserve and counterpart to Mervin King Governor of the Bank of England, has studied and lectured on the mistakes made during the Great Depression of 1930's and by the Japanese in the 1990's. His stance has been that on both occasions the authorities were too slow to supply liquidity to markets and too quick to end that strategy. This suggests that he is hardly likely to start tightening policy after just a single quarter of growth; especially whilst unemployment continues to rise.

There is, and will continue to be plenty of talk about what would be an appropriate exit strategy. Whether these central banks actually do have a plan this time is another matter. After all they have faced this situation before and have to date been fairly unsuccessful in their efforts to remove excess liquidity without destabilising the economy in some way. And to be fair there are some critical milestones in this process: first, quantitative easing would need to end. Then the process of when and how to raise interest rates without causing an imbalance would begin. And underlying all this is the threat of an inflation shock led by a spike in commodity prices to contend with.

For now an environment of low interest rates and low inflation will continue to support equities after a year that has seen asset classes like corporate bonds delivering equity

like returns with a fraction of the volatility. However, be aware that equities have rallied 50% from their lows and currently look ahead of themselves as measured by short term daily moving averages. So expect to occasionally see, as we witnessed in October, short term mean reversions. But, whilst no longer at bargain prices, equities are not far from fair value in terms of long historical price earnings ratios. Whilst I would not suggest that the current term trend can “boldly go when no man has been before,” we are unlikely to see a change in the long term trend whilst monetary policy continues to remain loose.

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**17<sup>th</sup> November 2009**

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