



Title: Managing Risks in Your Investments

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[SEE/SHOW SLIDE 2 – Some recent headlines] Investing is all about taking risk and I guess we can all be forgiven for taking a bit too much risk at the moment. Scanning the very gloomy pages from the City pages at the moment, it really does not make pretty reading and the risks of investing would appear too high at the moment. But we cannot just ignore these risks and hope they go away. Investing affects all our lives from our pensions, ISA's, PEPs etc, and really is all of our financial futures.

Today, I am going to cover three main aspects of investments. Firstly, portfolio diversification and how to reduce the risks within your portfolio. Secondly, how to avoid the next Marconi. Thirdly, have global stock markets now reached the floor and is it time to invest?

[SEE/SHOW SLIDE 4 – The right portfolio for you] When investing you must think, what is the right portfolio for you, how much risk you want to take, whether you want to preserve your capital and when you will want access to your capital. If next year then you do not want to be in equities because they are much more volatile, easily the most volatile of all the investment instruments. So you must think very clearly about how much of a time horizon you have. We would normally recommend a minimum five-year time horizon. Interestingly, equities have only had one five-year period since 1900 where they had under performed cash and bonds. Unfortunately they have just had another one but volatility does reduce significantly over periods of longer than five years.

[SEE/SHOW SLIDE 5 – Risk vs Return] Assess your appetite for risk and your need for income. An adage from the US is that your percentage of bonds should be equal to your age and it is quite interesting that, last year, Boots' pension fund switched out of equities and into bonds. Not because they thought bonds would perform better but because they had a relatively old and mature pension fund and it was right to get the security of the capital and income from bonds for their fund.

The key really is that diversification reduces the risk in your portfolio. You do not want to be in just one single asset class unless your appetite for risk is very high and you want to be at the equities end of investment on the right side of the graph (100% stocks) or a very low appetite for risk on the left (100% bonds). The risk along the bottom of the graph is a measure the volatility of the returns on the portfolio.

[SEE/SHOW SLIDE 6 – Potential to reduce.....] We can explore this further by examining how you might structure your portfolio. By using all three asset classes of

cash, equities and bonds you can actually increase your expected return for the same level of risk. Looking at the 'fixed income' portfolio versus the 'higher return' portfolio, the fixed income one has an expected return of 13.3%, risk 10.5% but on the higher return portfolio you have a return of 16.6% for the same level of risk of 10.5%. This is partly because asset classes move on different criteria. Therefore, you are smoothing your risk level out by having asset classes move around on different interest rate outcomes and different global situations.

We can also look to adding property to portfolios which is a highly topical situation at the moment. Recent figures from the Nationwide Building Society show that property is still rising by over 20% per year and there is a huge appetite in London for buy-to-let properties as people question the potential benefits of pension funds preferring to make property their pension fund. Property, particularly commercial property, can provide quite stable returns and can add quite useful diversification to a portfolio.

The general rule of not putting all your eggs in one basket still applies. To have all your investments in property is equally as risky as having them all in equities. You must also remember that property involves high dealing costs in terms of Stamp Duty, inefficient use of capital gains tax and it is very illiquid when you want to get your money out. So beware and one of our few clear messages to clients at the moment, in a time of extreme uncertainty, is that the buy-to-let property has probably peaked. Certainly it would do the equity market no harm if private investors start moving money out of property and back into equities.

Looking within equities, the main question we are always asked by private investors is how to construct investment portfolios. It is absolutely critical that you diversify this portfolio across a wide spread, both geographically and across sectors. It is as risky to be out of a sector as it may be to be in it. Even with a sector like telecomms, which did constitute a very large proportion of the FTSE 100, now down to about 7%, you must have a sector of that size represented in your portfolio. We will structure a client's portfolio with a minimum of BT and probably Vodafone as well. We would spread across a wide range of sectors, always financials including banks, insurance, always oils, always pharmaceuticals. Then we look for the best stocks within those sectors and other winners from really strong global players such as the Diagnostics, the Unilevers, the companies that will deliver solid returns to balance out the portfolio

In the same way as spreading your asset classes you can spread the geographical mix across the world. Interestingly, Japan adds a very useful diversification. The Japanese stock market has been a very disappointing performer over the last 10 years but it does move on different criteria from the US and UK markets which tend to be very inter-linked in the way they perform. Japan now has some exciting prospects going forward. It has a relatively younger population to boost the economy for shareholders' returns, and benefits from a lower oil price. There are also some strong moves being taken by the Japanese government in terms of injecting cash into the economy and buying bonds. Japan would be one of our favoured diversifications at the moment. For all of our clients, other than the relatively low risk ones, we will have a significant proportion of their investments in the US, in Europe and particularly Asia.

We also recommend the use of collective investment vehicles (investment trusts, unit trusts) particularly for any overseas exposure. It is unlikely that any private client is going to have a sufficiently large portfolio to want to have a big enough spread of equities in foreign countries to mirror what we do in the UK, whereby you have to have a broad spread of equity exposure in order to achieve a good return in relation to your level of risk.

We would also recommend that for smaller capitalisation stocks within the UK. Smaller companies can provide much more exciting returns than their bigger brethren can because they are capable of growing much faster and you would want to tap into that. However, to do that in a relatively low risk way means buying a lot of those stocks. So for the private investor we would recommend Aberforth's Small Companies Trust or 3i both very good ways of getting to the high growth end of the smaller capital markets in the UK and increasingly in Europe as well.

The next thing in terms of avoiding risk is how do we avoid the next Marconi or Railtrack. Unfortunately this is an art not a science. So we can not just enter numbers into a computer which will warn us because the risks are too high. There is an awful lot of guessing as to how much information is in the share price at the moment and how much risk is there going forward which is not discounted in the share price. As a general rule we do not want to buy shares for clients which are going to turn into a Marconi or Railtrack.

So what do we look for. We look for the ability to generate cash. Reports and accounts have had a very bad press over the last two years. It is sad day when US companies have to swear that their accounts really are a true and fair view. We had always hoped they were in the first place. Luckily it has not come to that in the UK and reports and accounts really are your best source of information on any company.

One of the lines it is most difficult for a company to be creative about is the cash balance. Turnover and cash tend to be pretty straightforward lines for a company to produce its report and accounts. It is not just where they are at the moment, but how they have been moving. Do retained profits equal increases in cash balances? Where a company is apparently retaining a very high level of profit but the debt always seems to rise as well then you may be suspicious that the profit figure is a pretty creative one. At the end of the day cash is what counts, cash is what pays dividends and interest on loans. A sure reason to be concerned about a company is when it does not seem to be able to generate cash.

Another thing we look at is how well the company is positioned. Is its business solidly enough founded to cope with more tricky market conditions? What are its competitors doing? Are they strong or weak? Are they going to be undercutting on price? Are they overseas and able to undercut because of strong sterling? How strong are these companies margins? If they have really high margins then are they sustainable and how good are their barriers to entry? Are they depending on one major customer like Marconi who were very dependant on BT which was taking 40-50% of Marconi's output at one time. Then BT ran out of cash and stopped ordering. One of the problems in the telecomms market was the amount of cash taken out of the industry to pay for the 3G licences which has had a knock on effect right through. Vodafone has had a very rough ride going right up and then right down. With the 3G licence auctions you could see the writing on the wall or even clearly hear the bells ringing.

Dependency on government handouts like Railtrack is now another thing to look out for. Although I kept my Railtrack shares, prepared to take the risk, we thought it was too risky for our clients because of its dependency on government.

Fraud, such as with Enron and Worldcom, is very hard to detect or predict. It is one of the few risks you cannot legislate for and has to be an area for the lawyers. If it looks too good to be true it probably is. We have seen that with these two companies as with Independent Insurance. You must be very suspicious when companies are growing extremely fast and apparently producing spectacular returns.

However risk is not just about avoiding the disasters. It is also making sure that you do not miss the next winner. The same rules apply as to avoiding the losers. Look for the companies that have a broad spread of customers, a strong business proposition and look as though they are really going to generate superior returns for investors for the next few years without doing anything too risky. Investor sentiment can make this very difficult where the stock market seems not very keen on a share and you may have to sit and ride out a year of it under performing. As long as the company's ground rules are not changed it should get there in the end.

One of my favourite companies is Tesco. It has consistently delivered to its shareholders and customers what they want. In the end shareholders will really reap the benefit building on its UK presence, building outside Europe and generating a truly global position. This is something that few UK retailers have managed to achieve. Tesco is out of favour at the moment and the theory is that food retail profits are under pressure and brands are in the ascendancy squeezing the retailers. Tesco is not generating as much money from Europe as was expected. However, this is a case of just riding it out. It will deliver and as long as it does not change track there is no need to panic.

Diageo, another great UK company, who by putting together Grand Met and Guinness had confidence that it would be better together and they would be way ahead of the competition. Now they are generating fantastic returns for shareholders. Looking at their share price since 1999 it is hard to believe that we have been in a bear market.

Others we like are Cadbury's, Unilever, a selection of the very boring British blue chip companies. BT are now doing a much better job but this is one where the ground rules did change. We were quite nervous of them 18 months ago but they sorted themselves out financially and look to be using their market share and position of market strength to their advantage now rather than running very scared of the regulator. It also helps that the rest of the competition have run out of cash! It could be the next winner so it is important to have a spread of those in your portfolio.

The simplest way for you might be to use a tracker fund which is very low cost way of investing where you buy what is called an i-share which gives you a track on the FTSE 100 and you do not miss the winners.

However, if we were really that good we would not be here today, rather on a yacht in the Bahamas. The only really guaranteed way of picking winners is by using inside information – no longer legal. A lot of doctors became very rich on the back of Glaxo in the 1990s because when they were shown Zantac they realised that many of their patients would be taking it for a very long time. That is a sort of inside information but legal. Occasionally you get that sort of opportunity, but sadly, not very often.

Finally, we have been hearing a lot about stock market six-year lows, so is the equity culture dead? Should you all say, I would prefer not to pay the price for that extra risk and stick with bonds? Very tempting but also a very risky strategy. Equities have historically produced the best long-term returns. Equities attract what is called an 'equity risk premium'. It is a measure of the superior return you get from equities over bonds. Over the long term it is about 2-3%. That compounds up to a considerable return over 10 years so you do not want your pension fund not to be in equities over that length of time.

There are quite good reasons to believe, even though the news seems quite awful, that equities might be somewhere near the bottom. What we are seeing is extreme volatility. Extreme volatility tends to come somewhere near the bottom with quite big dealing volumes and investor confidence shot to bits. All the news is awful and everyone is gloomy and that is usually the right time to buy. Interestingly, just looking for value there are some attractive yields out there with Boots currently yielding over 5%. Tobacco stocks are yielding over 4%. Banks are yielding 4,5,6,7%.

Really, the key now to the UK stock market beginning to out-perform is the concern over the insurance companies being removed. Since July, Equitable Life has sold over £2billion of equities which is a huge hit to the UK stock market. There are concerns now that Standard Life may have to follow suit so we need that sort of uncertainty to be removed. The FSA said recently that insurance companies were not as insolvent as people were rumouring but there is still this risk of this downward spiral where, if the market falls, they have to sell equities. Who knows what is going to happen with the insurance industry. Personally I would like to see some consolidation. There are some strong financial companies out there including the banks and there are some weak insurance companies and putting the two together might see one and one make a lot more than three.

So, are we near the bottom? It would be very nice to think so but the key message is that equities should form a part, the major part, of just about everybody's investment portfolio.