

ADVISER Investment

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A hint of green

As winter recedes, are there hopes that Baroness Vadera's much-vaunted "green shoots of recovery" may take root and thrive? It's tempting to accuse the business minister of false optimism, but several events last week hint the recovery may not be so far off.

Sir Philip Hampton, chairman of the Royal Bank of Scotland, spoke last week of "buoyant" corporate banking activity. And while he told the Financial Times it was "pretty brave to call a turn", it didn't stop legendary investor Anthony Bolton from doing just that.

Now president of investments at Fidelity International, Mr Bolton has made a long and distinguished career of making contrarian calls. But his sentiment was echoed by Jeremy Grantham, chief investment strategist at Grantham, Mayo, Van Otterloo & Co, who also sought to convince investors to buy equities before the onset of "rigor mortis".

Have we reached the bottom? The equities markets are certainly starting to creep back up, on the back of a recovery in the banking sector. Indeed, economic optimism has not been higher for 18 months, according to Ipsos Mori's economic optimism index.

While the index still languishes at minus 29 – determined by subtracting those who feel the situation will worsen from those who believe it will get better – it is still up a remarkable 11 points on last month.

If that were not enough, the number of City job vacancies has also started to creep up once more. The figures might be 62 per cent lower than this time last year, but month-on-month they are increasing.

So is there cause for hope? In a word, no. These are merely marginal movements. A far better analysis is the one conducted by the IMF that reveals Britain is still likely to be in recession in 2010 – by which time any green shoots will have withered and died.

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Comment

It is accepted that portfolio diversification is important, but structuring it can be tricky

The perplexing power of diversification

PHILIP
COGGAN



It is a basic principle of finance: a diversified portfolio is a better portfolio. Investors should not keep all their money in equities, lest they suffer a year like 2008.

But how should they diversify? Over the past decade, the fashion for institutional investors has been to move into alternative assets, such as hedge funds, private equity and commodities. Such a portfolio would, the experts calculated, have a much better balance between risk and reward.

The problem is the correlation between different asset classes does not stay constant. In the past decade, in particular, there has been a tendency for all risk assets to rise and fall together, as investors using borrowed money have piled in and out.

Take hedge funds. According to research from Richard Bernstein of Merrill Lynch, the correlation between hedge funds and the S&P 500 in the five years to 2000 was just 18 per cent, roughly the same as Treasury bonds. Adding hedge funds to your portfolio thus offered a much more 'efficient' outcome, defined as the best return for a given unit of risk.

But over the past five years, the correlation between hedge funds and the S&P 500 has been 96 per cent, making them effectively useless as a diversification tool.

Overseas – outside the US, in this case – equities have been even worse, showing a 98 per cent correlation.

Only two asset classes have had a negative correlation – tending to rise when equities fall, and vice versa. They are art and long-term Treasury bonds. Since art is not taken seriously by institutional investors – and since most British clients won't be able to afford a Damien Hirst – only government bonds really count.

Problems

But might buying Treasury bonds (or gilts) turn out to be a trap? The obvious problem might be that equities soar on the back of economic recovery while government bonds plunge on inflationary fears. That would be diversification, all right, but not a great help to clients. Also, Treasury bonds have not always moved in a different direction from equities; in the five years to 1995, they had a positive correlation of 72 per cent.

No asset class had a negative correlation in each of the five-year periods highlighted by Merrill Lynch. Art managed three out of four; gold, Treasury bills and Treasury bonds two each. An idea of the variability comes from the corporate bond sector: in the five years to 2005, it had a negative correlation of 56 per cent, but in the five years to March 2009, that correlation was a positive 57 per cent. Com-

modities had a negative correlation up until 2000, but a positive correlation pretty much ever since.

Gold has been a fairly good hedge. It has had a positive correlation over the past five years, but only at the 15 per cent level. Only in the very early 1980s did it have a significant link to equities. Real estate has not been a good hedge – for much of the past 25 years, the correlation has been above 60 per cent. Only in the period around the millennium did it move the other way from equities.

That suggests you need a combination of hedges. If you had gold, cash and Treasury bonds within your portfolio, you would have had at least one asset class with a negative correlation throughout the past 20 years. All three diversifiers could be bought at pretty low cost. You would also have a portfolio that hedges against both deflation and inflation. (Unfortunately, Merrill Lynch didn't run the numbers for index-linked bonds.)

But whatever strategic allocation you choose, it needs to be the subject of at least annual reviews. Financial asset classes are not like chemical elements, whose attributes stay constant over time. That's what makes the markets fascinating, but also so frustrating.

Philip Coggan is Buttonwood columnist for The Economist

Two sectors appear attractive at the moment: renewable energy and supermarkets

Where to search for long-term results

MARKET WATCH
STEPHEN BARBER



It is Isa season once again. As the end-of-tax-year deadline for subscriptions approaches, investors will be racking their brains

about the sectors and markets that will work hardest for their finances and perhaps preserve their capital. It's as tough a choice as any that has faced investors in the time Isas have existed.

Isa openings across the sector can be expected once again to feel the pressure of the economic environment. Last year, the industry had a tough year; nervousness can only add to the jitters this year. Nevertheless, research conducted by Selftrade suggests Britons are prioritising their finances. The findings showed nearly a quarter of those surveyed ignored this year's January sales, with a third seeing the need to build a serious savings fund. Roughly 15 per cent said they think longer term when investing.

I wrote in my previous column that for those disinterested in short-term speculative trading, the current market offers value – but perhaps only for those with a longer time horizon. Isas are a good wrapper for longer-term investing, combining wide choice with tax efficiency. And with many analysts talking of the cheapness in equities,

"Isa investors will want exposure to a range of markets and sectors"

where might Isa investors look and what approach might they take?

Building a diversified portfolio is important. Isa investors will want to gain exposure to a range of markets and sectors. Collectives are a good way of doing this, especially where portfolio size is limited. Beyond that, two sectors spring immediately to mind: renewable energy and supermarkets.

If ever there were a global sector that represented the future, it is new energy. With the realities of peak oil, global warming, population growth and emerging economy demand, there is a growing need for carbon alternatives. Approximately \$30bn (£21bn) a year is being spent on developing renewables – roughly a quarter of all investment in the energy industry. Negative growth could be good news for reducing carbon emissions, but

longer-term answers will lie in technology. In the Detroit car industry, companies that failed to invest in cleaner motors are suffering in the downturn. If US president Barack Obama is to offer a lifeline, then some of the funds are likely to be linked to green technologies. Nevertheless, a number of new energy projects have become casualties of the downturn, and we do not yet know which technologies will be adopted.

Supermarkets are easier to understand. In Britain, the sector is performing exceptionally well, given the state of the market. Defensive in the short term and offering some value, this is a sector whose solidity is attractive in the long term. Belt tightening has been good for the supermarkets as spending on luxuries has given way to the basics. The little burst of inflation we had earlier in the year also benefited their balance sheets, but the current disinflation and potential deflation will be harder to digest.

Isa investing in 2009 will be challenging, but for those with a long-term view and able to select winning sectors, it could be an opportunity to lock in some value.

Stephen Barber is head of research at Selftrade