
Professionals' View December 2011

No Such Thing As Risk Free:

There's real fear out there. As the Eurozone debt crisis appears to be entering some kind of final phase, we are receiving more calls from individuals who are genuinely concerned about preserving their capital. Those with memories of 2008 are questioning the security of the very banks that hold their cash. The most common request at the moment seems to be for investing their money in something "safe", in something with no risk. There is no such thing.

European End Game?

The situation in Europe is showing signs of deteriorating quite quickly. In less than a month, Italian and Spanish bond yields have risen to more than 7% (the point at which bail-outs were triggered for Greece, Portugal and Ireland). More significantly, they didn't just spike this time. Even more significantly, French, Austrian and Belgian debt saw its' yields rise to dangerous levels and Germany failed to get all of their bonds away in an auction that was probably the clincher in terms of making the politicians sit up and take notice that this thing **just will not go away** without drastic action.

Also within the last month we've witnessed changes of government in Greece and Spain. In August we said that democracy was one of the main problems with this crisis. Well, neither of these new Governments was democratically elected in what could be a telling shift towards Federal unity. Most people outside Germany seem to have reached the conclusion that this crisis will only be halted when the European Central Bank (ECB) becomes the lender of last resort and puts a firewall around the sovereign debtors. The ECB and Germany don't share this view – yet; the former because they claim that it is actually illegal for them to do so and the latter because they've had experience of going shopping with wheelbarrows instead of wallets as an inflationary fire took hold. It all feels as though we are hurtling towards an **event** that forces the ECB's hand. Quite what this **event** will be is unclear. Unfortunately, quite when this **event** will happen is also unclear. And herein lies the problem for anyone who is risk averse.

The Risk Of Holding Cash:

Normally, cash is the best risk-free asset, but apart from only being guaranteed the first £85,000 of your money should your bank go bust (one suspects that the banks and authorities themselves don't know the full extent of banks' liabilities in the event of a European sovereign debt default, so how on Earth can we be expected to know?) we also have the major problem that interest rates are significantly less than inflation. This means that the only **guarantee** of holding cash for long is that you lose money in real terms as inflation gnaws away at its spending power. This doesn't sound risk free. So, surely, if inflation is the worry, you simply hold your cash in index-linked gilts?

The Risk Of Holding Index Linked Gilts:

If we knew for sure that inflation was here to stay, these would be the perfect risk free investment. But we don't. Mervyn King has continually said that inflation is artificially high in this country, and we agree with him. The one-off VAT rise will disappear from next year's calculations, while oil prices have subsided a little from their highs earlier this year. Food prices also spiked earlier in 2011 so, with workers striking more to protect their jobs rather than demanding more money, wage pressure on inflation looks non-existent so the inflation rate could easily fall. If it does, so does the return that you receive from index linked gilts, but more importantly, so does your capital value as the flow into "linkers" reverses. This doesn't sound low risk to us. So why not hold traditional gilts?

The Risk Of Holding Traditional Gilts:

Gilts have been described as "return free risk" lately. This may be a little unfair, but it highlights the fact that they are far from risk free.

Traditionally gilts are portrayed as low risk safe havens, and to a certain extent they have displayed these characteristics during periods of market nervousness (some may say panic). But it is the very fact that they have been so sought after that has led them to offer very little by way of yield (like cash, below the rate of inflation) and their capital values appear exceptionally high. "At current prices, UK

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10 year gilts would stand to lose 20% if bond yields rose to match current levels of inflation," says Patrick Armstrong of Armstrong Investment Managers. This doesn't sound low risk to us. How about holding gold? That's portrayed as being a hedge against inflation isn't it?

The Risk Of Holding Gold:

Gold has been a fair option as a safe haven since the credit crunch hit and it appears that it is still attracting investors at sovereign as well as domestic level. However, gold pays no income and is thus totally dependent upon capital values rising in order to deliver any return. It does not seem that long ago that we were talking about gold breaking through the \$1,000 an ounce level. It now trades at around \$1,800 an ounce, having touched \$1,900 a few weeks back. It fell very sharply from \$1,900 to \$1,600 in just a few days' trading. Gold, therefore, is volatile. This doesn't sound low risk to us. So what about corporate bonds or equities? They (mostly) pay an income and that income is currently higher than you can get from cash or gilts.

The Risk Of Holding Corporate Bonds And Equities:

The risks of holding these are well known. There is an argument in favour of corporate bonds being lower risk than some sovereign bonds at the moment, but the fact remains with corporate bonds that if the company to whom you've lent money fails to pay you when due, you lose. Values in general tend to fall when there is talk of recession (as there is now) and equities are volatile on a daily basis. Bearing in mind that the FTSE 100 was at around 6,700 in March 2000, and that it is now flirting with the 5,000 level some eleven and a half years later, it takes a leap of faith to see equities as anything other than a pretty risky and poor investment over the longer term that has been this past decade.

However, **at some point** the Eurozone debt crisis will reach its end point (at least temporarily). When it does, and investors emerge from their burrows [bunkers would be more appropriate : Ed] we expect to see a sharp rally in equities as their low valuations and higher yields become exceptionally attractive in comparison to the low gilt yields and cash interest rates existing now. Gilts will fall in

value, as will gold in all probability, thus triggering distress to those who have sought low risk shelter in such assets. But before this happens, we expect an **event** to occur, with the likely consequence that equities get a fair bit cheaper first.

So, risk-free investing does not exist at present. How long this continues is anyone's guess (and guessing it is, despite what some commentators will claim). The **only** sensible thing to do in our opinion is to try as best you can to diversify your investments in such a way as to cover as many bases as possible to cope with whatever the world throws at us in the coming weeks. Doing nothing is risky. Investing too much in any one asset class is risky. In short, we have to accept that risk is an integral part of holding **any** asset at present and that managing that risk is the most that can be achieved. The first step though is to recognise the risks that exist.

There are a number of so called "low risk" products being peddled at the moment. Our advice is to tread very carefully if you are tempted by one as what is low risk one day can turn toxic the next.

Feel free to ask us specifically on any of these issues.

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