Finding clarity in an uncertain time

By Tom Stevenson , 2 June 2010

Investment strategies for when everything is up in the air.

Hamlet's troubles came not as "single spies but in battalions". Investors will know what he means as they grapple with a seemingly endless list of uncertainties and search around for an approach that makes sense in a turbulent world.

Top of that list is obviously the upheaval in the eurozone, but there is plenty more for investors to get to grips with, from tightening in China to the Aussie mineral tax, onerous new regulation in America to conflict or the potential for unrest in Korea, Thailand and Gaza.

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Add to that the BP oil spill, turning out to be possibly the biggest environmental catastrophe since Chernobyl, and the threat of volcanic ash disrupting air travel for years to come and it is no wonder that markets have paused after their breathless rise since March last year.

Hindsight is a wonderful thing. Everything seems clear looking back but of course investors never have the luxury of 20:20 rear view vision.

Out on the road this week talking to Fidelity clients I have been reminding investors what it felt like in the early 1980s when there were some parallels with today's turmoil (and a few differences too) – UK soldiers were on their way to war, inflation was a concern, unemployment sky-high and Britain had been cap in hand to the IMF after a currency crisis. There were riots on the streets of Liverpool and London.

Interestingly, the market at the end of 1981 had risen pretty steadily for five years (albeit much of the gain was illusory, a function of inflation). So how did it feel as an investor at the time? Pretty awful actually – few were prepared to dip their toes into the market at the time, with the outlook so poor.

But over the next five years, the market went on to double again as the Thatcher government's harsh medicine, and the same treatment on the other side of the Atlantic, began to take effect. The lesson looking back is clear – there are risks to being out of the market as much as to being in it; and, predicting the future of investments is near impossible from a simple analysis of the prevailing economic situation.

For investors, the uncertainties today are no less extreme than those for the bigger economic and geo-political picture.

Here are some of the known unknowns I've been discussing with our customers this week:

Inflation. Rarely can I remember a time when there have been such divergent views on whether prices are set to rise or fall. With emerging markets experiencing high inflation while the developed world grapples with deflation there's a strong case to be argued for both outcomes.

Another possibility is that short-term deflation could be replaced by longer-term inflation. It’s a confusing picture and one that matters enormously to investors because rising prices mean that they should be exposed to commodities, property and equities while falling prices argue for bonds and cash.

Many of the old certainties have evaporated too. For many investors residential property has been a fantastic hedge against inflation and the source of serious capital gains over the years. But how does the outlook appear today with house prices overvalued on so many measures and credit availability, interest rates, CGT and unemployment all urging caution.

The biggest uncertainty is on our doorstep. The eurozone is experiencing its greatest crisis in its 10 year history and few would confidently predict how the fiscal turmoil will resolve itself. The fundamental flaw of a monetary union within a fragmented political and fiscal framework is now clear to all. Is the political will there to hold it together? Perhaps more to the point, is the public will there to accept the austerity measures that will be required to rebuild a sustainable future for Europe?

Plenty of other uncertainties have been chewed over in our discussions this week: will gold provide the safe haven it is renowned for at times of anxiety about paper currencies; how will the Government’s deliberations over tax (especially CGT and pension contribution relief) turn out when Mr Osborne presents his first budget on June 22?

Not all the surprises are negative either. It is easy to forget amid all the turmoil that global GDP is rising and expectations have actually picked up so far this year. Corporate earnings are beating forecasts and sales are rising too, so this is not just about cost-cutting either.

Valuations are not demanding either, with shares in Europe trading at a lower multiple of earnings than the average over the past 25 years or so. Importantly, the average dividend yield on a share is currently running ahead of the yield on a government bond. This is a rare occurrence, only happening in recent years at the bottom of the market in 2003 and again at the height of the financial crisis in 2008.

Some of the strategies we have been discussing to deal with all this uncertainty are recurrent themes in these columns but worth repeating nonetheless. I’ve been talking about the importance of diversification: with emerging markets, for example, topping the performance tables one year and falling the most in the following 12 months, choosing this year’s winning asset class is next to impossible. Putting your eggs in a range of baskets is key.

I’ve also been making the case for stock-picking in an uncertain world. With such a significant divergence in performance between the most attractively valued shares in the market and the least attractive ones, it is hard to argue for gaining access to a market via a passive fund. Picking the winners and avoiding the losers should be the aim of any investor and investing in the best funds which make that their goal is the best route for most of us.

Taking a contrarian approach to buying the market when it is most out of favour has been another theme that has provoked debate. The lost decade for shares over the past 10 years, if history is any guide, points to better times ahead.

Taking advantage of better markets will require some lateral thinking, though. Everyone knows the emerging markets story but sometimes the best way of tapping into it is not the obvious play. The Chinese railway boom, for example, might best be played via a European railway parts manufacturer trading at an undemanding rating – the growth in Latin American telecoms via a European phone company.

I’ve been struck this week by the great interest shown by Fidelity’s clients in the investment opportunities and challenges facing us all in this unprecedented turbulence. As the Chinese curse says: may you live in interesting times.

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