RETURNING TO FIRST PRINCIPLES

By almost every measure the last year has been the most volatile and unpredictable for investments that anyone can remember. We have watched with a combination of concern and astonishment as the global financial situation has unfolded. As we read and research we have reviewed what this means for our clients and considered what effect, if any, this might have on our financial planning and investment principles.

HOW DID IT GET TO THIS?

It is not too strong to say that at its root the so-called Credit Crunch (defined as: 'a severe shortage of money or credit') was caused by a society-wide *credit addiction,* both by private individuals and institutions (In a previous newsletter we described the problem as 'greed on the part of borrowers, banks and shareholders'). Recent news seems only to underline this analysis. To this extent, it is too simple to blame all of what we are now experiencing on the banks alone, although undoubtedly their part has been substantial.

Whatever the various and complicated sequence of events that led to the current economic crisis, one thing is for sure and that is that we are now in the grip of a recession. Unlike previous recessions which have been regional or country-specific, this recession is truly global with even emerging economies that were thought to be immune being affected (e.g. Chinese imports are down and Russia's currency has been devalued and its stock market has fallen).

A number of measures are currently underway or being considered at a national and international government level to try to stimulate recovery. For example in the UK we have seen both fiscal measures by the UK Treasury, such as VAT reduction, cash injections to banks etc, plus monetary policy by the Bank of England, such as interest rate reductions and even potentially quantitative easing (what you and I might describe as 'printing money'). The effectiveness of these strategies is of course not yet known.

HOW SHOULD WE RESPOND?

How do we begin to respond to all this doom and gloom? Over the years we have, through our newsletters and through the advice we give our clients, sought to outline a number of money management and investment principles.

The nature of principles is that they should be timeless and offer sound guidance regardless of the current circumstances. Nevertheless, we have asked ourselves searching questions:

- Have the rules changed?
- Should we think short term instead of long term?
- Should we try and time the market – taking an educated guess at when it will hit bottom … and when it will hit top?
- Should we cease to diversify and instead try and concentrate in one sector of investment?
- Do our risk profile models need to change?
- Are our asset allocation models still robust?
- Should we change to a different investment philosophy (such as for example *core & satellite*)?

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Whilst being open to new ideas and wisdom we have concluded that, although there are a lot of questions being asked at the moment, no one has any better answers than the principles upon which we have founded our advice for over 10 years now.

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They are based on ancient wisdom and have seen us through some significantly challenging cycles (the currency collapses 10 years ago, the technology bubble and the millennium bug at the turn of the century, 11 September 2001, the collapse of Enron, Worldcom, Arthur Anderson and various hedge funds, the Iraq invasion).
We feel that our feet are standing on rock not sand when we rely on these foundational principles.

General Money Management Principles:

1. Spend less than you earn – live within your means;
2. Maintain sufficient savings – keep a sufficient short-term cash reserve to meet emergencies and specific goals and build up savings to meet your long-term objectives;
3. Avoid the use of debt where possible – this does not mean don't take on debt but if possible be debt averse and question whether it is really necessary to take on a debt;
4. Plan ahead – try to have the future in mind when you make financial decisions rather than just react - (on the basis that the longer range your perspective, the better your decisions).

Lessons from history

Notwithstanding the fact that the current economic slowdown has happened so fast and that some of what we are experiencing is unprecedented, it is worth reminding ourselves of the pattern of previous recessions and in particular those assets that have performed well at different phases of the economic cycle:

Slowdown phase	Recession phase	Recovery phase	Expansion phase
Cash / Fixed Interest	Shares/ Fixed Interest	Shares/ Property	Shares/ Property

In the slowdown phase investment markets lose ground as the economy slows and cash is the only safe haven. During the recession phase, markets tend to rise anticipating better times to come. Markets then tend to rise further as the recovery phase sets in.

As we have already said, it seems clear that we are now moving from the slowdown phase into the recession. However, the difficulty is that we cannot with certainty predict the length and depth of this recession. It is clear too that in the short-term cash deposits are producing very low returns (in many cases less than the rate of inflation).

At the risk then of repeating what we have said many times before we must conclude that the appropriate response is still to pursue the following investment principles:

Savings & Investment Principles:

1. Don't try to time the market – (the bottom or the top) for any asset class. There are few people who can do this with a high degree of success, instead:
2. Diversify your investments across different asset classes to provide both a measure of protection from the downturn of any one asset class and provide you with some exposure to the best performing asset classes across the economic cycle. Diversification reduces volatility whilst improving returns.
3. Take a long-term view – (Yes, this one again!) it may be a very good time to start making new investments for the long term. In 10 years' time it is unlikely that investments will be worth less than they are today.
4. Avoid any investment that you don't understand – complex structured products that seem too good to be true probably are!
5. Only use investment institutions with an established track record and of reasonable size.

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