



## SCM PRIVATE

### Don't Panic, Process – Alan Miller, Chief Investment Officer, 9 August 2011

The outlook appears gloomy - US politicians have managed to undermine confidence through an inability to respond quickly and with common sense, many European governments have too much debt, economic growth has disappointed and consumers are not spending more. Is all this bad news much worse than expected when the developed world has too much debt and thus there was always going to be a slow recovery? At SCM Private we do not think so.

But is there any good news? Yes there is. The best news is that prices have been smashed, valuations are exceptionally low, corporate balance sheets are exceptionally strong and the emerging economies do not have the same debt problems. The market is a discounting mechanism. It takes a view of the future and discounts this into prices. At the moment the markets are pricing in a severe recession, but in my view this currently seems unlikely.

Let's take an example of UK equities (see table below showing prospective earnings ratios and yields of major stock markets). The blue chip FTSE100 is on a prospective PE Ratio of less than 9x and a yield of 4.2%. Overall earnings and dividend growth has been strong with corporate earnings forecast to grow by 14% this year and dividends by 7%. In effect UK and most world equities are about 25% cheaper than only 6 months ago as the combination of lower prices and higher earnings have de-rated stocks.

World Equity Index Ratios				97) WEI	98) EMEQ	
Measure	Price/Earnings			Price/	Curr Yr	Nxt Yr
1) North/Latin America		Price	Net Chg	Earnings	Est.	Est.
4) INDU	DOW JONES INDUS.	11019.64	+209.79	11.85	11.11	9.84
5) SPX	S&P 500 INDEX	1144.78	+25.32	12.54	11.51	10.09
6) CCMP	NASDAQ COMPOSITE	2418.94	+61.25	18.64	14.42	12.01
7) SPTSX	S&P/TSX COMPOSIT	11923.14	+252.18	16.29	13.24	11.19
8) MEXBOL	MEXICO IPC INDEX	32127.57	+411.79	16.28	13.64	11.13
2) Europe/Africa/Middle East						
9) SX5E	Euro Stoxx 50 Pr	2252.31	-34.60	9.10	8.06	7.27
10) UKX	FTSE 100 INDEX	5040.35	-28.60	10.24	8.96	8.04
11) CAC	CAC 40 INDEX	3108.03	-17.16	9.02	8.25	7.47
12) DAX	DAX INDEX	5822.47	-100.80	9.36	8.76	7.70
13) IBEX	IBEX 35 INDEX	8311.90	-147.50	7.17	8.75	7.78
14) FTSEMIB	FTSE MIB INDEX	15408.04	-231.71	10.34	8.06	6.86
15) AEX	AEX-Index	280.48	-2.88	8.75	8.24	7.46
16) SMI	SWISS MARKET IND	4870.36	-97.63	13.12	10.73	9.28
3) Asia/Pacific						
17) NKY	NIKKEI 225	8944.48	-153.08	17.04	14.92	12.91
18) HSI	HANG SENG INDEX	19330.70	-1159.87	9.39	10.33	9.11
19) SHCOMP	SHANGHAI SE COMP	2526.07	-.75	13.98	11.59	9.69
20) AS51	S&P/ASX 200 INDE	4034.80	48.70	13.84	10.59	9.55
21) FSSTI	FTSE STRAITS TIM	2884.00	-110.78	8.26	13.19	12.00

Source: Bloomberg

Measure 5 Dividend Yield				97) WEI	98) EMEQ	
1) North/Latin America		Price	Net Chg	Dividend Yield	Curr Yr Est.	Nxt Yr Est.
4) INDU	DOW JONES INDUS.	11022.48	+212.63	2.73	2.87	3.08
5) SPX	S&P 500 INDEX	1145.25	+25.79	2.23	2.29	2.51
6) CCMP	NASDAQ COMPOSITE	2419.22	+61.53	1.13	1.45	1.55
7) SPTSX	S&P/TSX COMPOSIT	11941.72	+270.76	2.84	2.91	2.95
8) MEXBOL	MEXICO IPC INDEX	32177.56	+461.78	1.60	2.52	2.79
2) Europe/Africa/Middle East						
9) SX5E	Euro Stoxx 50 Pr	2257.17	-29.74	5.28	5.80	6.36
10) UKX	FTSE 100 INDEX	5047.47	-21.48	3.94	4.20	4.63
11) CAC	CAC 40 INDEX	3108.03	-17.16	5.05	5.34	5.81
12) DAX	DAX INDEX	5830.77	-92.50	4.14	4.41	4.86
13) IBEX	IBEX 35 INDEX	8319.60	-139.80	5.75	7.53	8.09
14) FTSEMIB	FTSE MIB INDEX	15425.79	-213.96	5.26	5.72	6.44
15) AEX	AEX-Index	280.48	-2.88	4.05	4.30	5.27
16) SMI	SWISS MARKET IND	4875.55	-92.44	3.02	4.33	4.82
3) Asia/Pacific						
17) NKY	NIKKEI 225	8944.48	-153.08	2.10	2.11	2.13
18) HSI	HANG SENG INDEX	19330.70	-1159.87	3.38	3.93	4.40
19) SHCOMP	SHANGHAI SE COMP	2526.07	-.75	1.92	2.54	2.90
20) AS51	S&P/ASX 200 INDE	4034.80	48.70	4.91	5.36	5.84
21) FSSTI	FTSE STRAITS TIM	2884.00	-110.78	3.89	3.39	3.67

Source: Bloomberg

Even if you choose to forget the earnings and just look at that dividend yield - you can now get over 4% pa from companies with strong balance sheets and where dividends are likely to grow over time or 2.7% pa from the UK government which arguably has a higher credit risk and where the yield is fixed. Which would you prefer to have? Look at the graph below and you can see for most of the recent past, UK government yields were higher than UK equities. In the last 11 years apart from the post Lehman's global meltdown, there has not been a chance to buy equities as cheaply compared to bonds. As the bottom graph shows, the ratio of 10 year UK government bond yields to FTSE 100 equities yield is just 0.7x – for most of the last 11 years UK government bonds have yielded 1.5x equities.



Source: Bloomberg

Look at the price of commodities recently - they have collapsed. It seems therefore strange that given lower economic growth and falling material prices, investors are still worried over inflation.

## How SCM Private Are Positioned and What Asset Allocation Changes Have We Done?

In terms of overall equity exposure the Long-Term Return Portfolio has about 73% in equities and the Absolute Return Portfolio has about 53%. The majority of the exposure is in developed world blue chips with some relatively small exposure to China and Turkey. In bonds we hold corporate and emerging market bonds mainly with yields of typically 5% vs 2.5% for western government debt.

Recently we have been adding to our equity exposure but in small measured steps and mainly via the FTSE100 which is international in nature, lowly valued and of course avoids the additional currency risk of investing overseas. We have sold much of our index-linked exposure which has performed very well and which now is priced to perfection in our view.

We are determined to look past short-term noise and panic and focus on long-term values. We do not want to be in a position of looking back and saying why didn't we buy those stocks in August 2011 when there was this once in a few years clearance sale?

One of the best short-term indicators of sentiment is the VIX which shows the implied volatility of stocks – when people are nervous they demand a very high return to write options on stocks as they perceive them to be extremely risky or volatile, thus the VIX is high. Often when the VIX is very low, the market falls, and when it is high, the market rises as perversely the market tends to go up when everyone is nervous and go down when everyone feels comfortable. Look at the recent spike, again the highest since equities started performing so well last summer. In short, don't panic Mr Mannering!



Source: Bloomberg