

# Time for a REALITY CHECK

It is hardly surprising many investors are feeling perplexed. On the one hand, share prices have rallied from their recent lows while, on the other, economic data are still poor – even if the rate of decline appears to be slowing.

However, if you believe it's time to venture back into financial markets, where is the best place to invest? Against this unsettled backdrop, it's worth taking the time to reassess the major asset classes and examine their fundamental attributes in the context of the current environment.

## Equities

Shares in listed public companies provide investors with the opportunity for capital growth, often accompanied by regular dividend payments. Historically, equities have performed better than many other asset classes – however, recent events have proved that, as a group, equities can also perform exceptionally poorly. Although prices have rallied recently, they remain considerably below their highs and some investors might find it difficult to accept the claim that equities usually outperform bonds and cash deposits.

Nevertheless, share prices have fallen across the board, meaning shares in high-quality companies are still undeservedly cheap. The events of the past two years should not necessarily deter investors from future investment in equities, although it is worth re-evaluating your investment goals and appetite for risk in order to ensure that equities remain a suitable investment. In addition, it is vital to ensure that equity investments are properly diversified. The last two years have provided us with a painful reminder that share prices really can go down as well as up.

## Fixed income

Bonds tend to carry a lower rate of risk than equities, offering a regular income stream with some limited potential for capital growth. Bond prices and yields are affected by changes in rates of interest or inflation, and individual bonds are influenced by company or sector-specific newsflow.



UK interest rates remain at record lows, boosting the attractions of bonds compared with cash. Equity investors are re-examining bonds as a possible alternative to equities while many UK companies have been reviewing their dividend policies – and cash-strapped companies have been cutting or cancelling their dividends, thereby increasing the charm of fixed-income investments. Nevertheless, there is still a higher-than-usual risk of default within the corporate bond sector and, like equities, diversification and a focus on quality are essential.

### Property

Property provides the potential for capital growth with a regular income stream from rent. Historically, investments in property have provided relatively high returns; however, recent events have demonstrated that the market can be both volatile and illiquid.

House prices slumped following the formation of a “bubble” in the sector that was fuelled by indiscriminate mortgage lending and strong demand in the “buy-to-let” subsector before the effects of the credit crunch and the recession combined to exert downward pressure on prices. Some borrowers have fallen into negative equity, and a growing number of households have seen their homes repossessed. Nevertheless, there are signs that the pace of decline is slowing – although a revival in the sector is unlikely until financial institutions show more willingness to lend.

### Commodities

Commodity prices are driven primarily by supply and demand while returns are affected by geopolitical developments and macroeconomic events. As a result, commodity prices are very volatile, and can rise or fall suddenly and dramatically.

Commodity prices soared during 2007 and 2008 amid booming demand from developing nations. However, the onset of recession led demand for many commodities to slump and prices subsided. More recently, prices have rallied amid hopes that the global recession might have bottomed. Commodity investments are relatively risky – nevertheless, returns tend to have little or no correlation to the movements of financial markets, and therefore commodities can provide useful diversification benefits to a portfolio.

**NOBODY KNOWS WHAT THE FUTURE WILL BRING, SO DIVERSIFICATION IS LIKELY TO PROVE YOUR MOST VALUABLE WEAPON**

### Cash

Cash possesses undoubted attractions as it is highly liquid and relatively low-risk. Nevertheless, cash provides no protection against inflation, which erodes its real value over time. Moreover, in the current environment of exceptionally low interest rates, it is difficult to obtain a meaningful return on cash deposits.

Although the risk of a UK bank failure is extremely low, the experiences of UK depositors in Icelandic banks show that cash deposits are not necessarily risk-free. When choosing a deposit account, investors should take the time to pick a suitable institution and account, and be aware of the terms and limits of any statutory compensation schemes.

### The importance of diversification

Above all, investors should remember that returns from a portfolio that is diversified across a range of asset classes are likely to be less volatile than those from a portfolio that focuses on a single asset class. Different asset classes tend to perform well or badly at different times, and a diversified portfolio helps to reduce overall risk by spreading it across a range of asset classes. Nobody knows what the future will bring, so diversification is likely to prove your most valuable weapon in the fight against the unknown.

**If you have any questions about your own portfolio or would like to discuss the best mix of investments to meet your needs at this time, please give us a call.**