insight
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Bubbles

Bubbles is a great pre-Raphaelite painting by Millais in the Lady Lever Art Gallery in Liverpool, lent generously by Unilever, well known for its Dove soap, amongst many other brands. It is fascinating to watch bubbles grow and then of course they burst. Soap bubbles don't cause a problem, other varieties might.

An investment bubble is a human psychological phenomenon but with serious financial implications where much money can be made, and as it bursts, much money lost. The South Sea Bubble is the most famous in the UK, where a company with little value became a massive speculation and grew in price because people thought it would grow in price, not because of its value. The sage of Omaha, Warren Buffet is a value investor and has said that the price of a stock is what you buy it at; the value is something completely different. He never predicts what will happen to markets, he looks to buy only when his calculation of a stock's intrinsic value is considerably more than the price. He thus avoids the main problem of bubbles- when to get out.

We hear sometimes of share momentum investing where we are told of the weight of money about to go into shares generally. We are hearing some of this now, partly because most other assets look very poor value.

One of the main investment themes, and indeed one we have been mentioning for a long time, is the rise of emerging markets. We have especially been keen on the Far East (excluding Japan) before it became fashionable. The Far East and Emerging Markets are often lumped together, and we do now see some dangers in these areas, and really good investment management here is essential, as whilst some emerging markets in share price terms will continue to do well, in others it is difficult to see any rationale based on value in them doing well in the short term.

It was the head of Goldman Sachs who first coined the term BRIC, standing for Brazil, Russia, India, and China. These are the biggest of the emerging markets, but they are not the only ones; and I see danger in each of them, not in the long term, but in the current prices. Brazil has and is a popular place for foreign investors who have been buying its currency because of its strong economy. However the Brazilian authorities don't like this because it increases the costs of all its exports, and has been trying to physically ban the buying of its currency for speculation purposes. In China, house prices are a bubble in certain areas. The Financial Times reported rather jokingly that a peasant would have to work full time since the end of the Tang dynasty in order to buy a flat in Beijing. The Tang dynasty ceased in AD 970. In Beijing the minimum basic wage increased by 20% last year. In Russia, the rule of an independent judiciary, and freedom of speech seem to be weakening and the rise of intolerant nationalistic groups reminiscent of the Brownshirts of Germany in the 1930's, particularly worrying. That is a political statement, but it has economic implications. In India, the stock market prices are high, the average Price to Earnings ratio being 23 (in the UK it is 12).

You may be asking whether that means that Emerging markets should not be bought. I am not saying that, but I am saying blanket buying is not good, but selective buying in many markets is certainly worth it.

Image source: http://www.liverpoolmuseums.org.uk/picture-of-month/displaypicture.asp?venue=7&id=299

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The last 10 years have seen poor returns for the stock market indices of the US and UK, but the starting point was in the technology bubble, when the indices were too high anyway. Nevertheless, some of the Funds **we** chose did really well showing how important it is for really good day to day management. However some dramatic longer term facets have emerged in this time period. The following are the most important in my view:

The traditional certainties for investors have vanished. The long term deflationary pressures have gone, and the reaction to the banking and credit crisis has unknown yet to arrive effects. However it is likely to produce inflation at some stage.

The emerging markets will continue to outstrip economic growth in the West. This is partly because they are starting from a lower base, but also the West has so much debt to repay that it can't grow at a great pace. How well each of them manages this growth will be the determinant of the stock market behaviours. There will undoubtedly be some political effects of this growth and they are unpredictable.

The Euro crisis is serious. Was it a silly idea in the first place? (No, but too early and badly executed). However to leave the Euro seems to be worse than staying in. My prediction is that many Europeans will have nil increase in standards of living for two or three years, and we have not seen the end of civil unrest. There will continue to be parts of Europe that do well (e.g. Germany), but Greece, Portugal, and importantly Spain will be in the news this year. The Euro will survive but at a severe price in sovereignty for some.

Will the US Dollar still be the World's reserve currency? I don't think the certainty is still there, but what would replace it?

I suppose that all sounds rather depressing, but it isn't. There have always been problems. We still have the highest standard of living ever. Harold Macmillan was right then and Lord Young was right last year. Our standard of living is likely to increase, but certainly with difficulties especially in the first part of this year and of course not uniformly, as the difficulties will fall on some more than others and investors, as always, should look for value vis a vis the price, diversify, always have sufficient cash and make sure the managers are agile. (That is our job).

Just a reminder that predictions are always difficult. In the World Cup last year it was after all, the octopus Paul who got it right more than the experts. Sir Alan Budd the original head of the Office for Budget Responsibility has said that forecasts are always wrong, and the views of the "experts" for the FTSE 100 at the end of 2011 vary from 5,500 to 7,000.

What I **do** predict is that it will be an interesting year.

Best wishes and Happy New Year!

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