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EQUITIES

SELECTING THE BEST TRAJECTORY FOR STOCK MARKET RE-ENTRY

The wealthy investor, rendered wary by several stormy years, is preparing to step back into the world of equities. Felix Lanters offers a guide to picking the right investment strategy and the appropriate manager

He did not give up without a fight, but the dreaded bear seems finally to have retreated into hibernation. Investors can emerge from behind their piles of cash and bonds, and venture back into equities.

Global equity markets, driven by less political pressures and improving economic circumstances, are looking stable again after the bumpy ride of the last few years. A reasonable estimate would be 10-15 per cent growth in world markets for 2004.

The outlook for the next few years is one of positive, if relatively modest, growth in global economies, combined with low inflation and thus very limited upwards pressure on interest rates. In such an environment, we should expect ongoing profit growth and maybe some room for expansion. We could continue to see quite reasonable returns, of around 10-12 per cent a year, in the longer term.

Moreover, the equities picture can only look the brighter for comparison with fixed income, where yields are very depressed, and investors are looking for higher returns. Figure 1 (on page 36) shows that the MSCI World has beaten the Lehman Aggregate since April 2003, over which period it has steadily increased its lead over the fixed income indicator.

So far, so simple. But questions remain. Which equities? Which markets? Which sectors? How to pick the investment strategy and manager appropriate for each high net worth individual (HNWI)?

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Felix Lanters, ABN AMRO Asset Management

REGIONAL VIEW

Figure 2 (on page 36) shows the differences in equity returns across different regions. Looking forward, the Asian story looks set to continue positive, and China in particular should be seen as one of the big global engines, which could go on for some time. Outside the region, and although it comes with slightly higher risk, Russia is another area with distinct possibilities for a shrewd equities investor.

In Europe, structural reform means the gradual removal of barriers and increased flexibility in labour markets. Reforms may be slow, but they are coming through, and this means positive expectations over the longer term.

While it makes more sense to focus on sectors across the region rather than on individual small economies within Europe, it is worth noting that the recovery should be greatest in those markets, notably Germany, which have struggled most with their economies over the past year.

As a part of the European Union, the UK should benefit from the dropping of barriers in Europe. It also boasts a fairly flexible labour market and a relatively company-friendly environment. But the relative advantage is probably going to be less than on the continent.

In the longer term, it is more constructive to look at individual companies and their positioning within global industries. There are many UK companies that will do well because their global sectors, for example, pharmaceuticals or financials, are very strong.

The US has, of course, led the current upsurge in global economies, but it is difficult to see where a continuation of income and growth would come from. In the short term, valuation levels in the US are considerably above those in the rest of the world, so investors should approach it that bit more carefully.

GLOBAL VIEW

In general, however, it makes sense to look at the world in terms of global sectors, rather than cling too tenaciously to regional divides.

Looking across industries, at a global level, we note that the strong recovery of last year was driven by high beta low valuation stocks. Generally, heavy cyclicals did well. However, the valuation upside is becoming more limited.

As the global economy moves to longer term growth, the environment should favour sectors that offer sustainability and growth over the long term. These include sectors such as pharmaceuticals and healthcare equipment, but also areas including general retail, household and personal care.

The next question is how to make the step back into equities. The strategic breakdown of a client's portfolio will depend on individual preferences, risk profile and time horizon, as well as any expenses he is facing.

It goes without saying that asset allocation should be highly tailored to individual needs. What can be added more generally, however, is that, whatever a HNWI's benchmark, now is the time for him to go overweight in equities.

Unsurprisingly, the way to do this depends to some extent on the HNWI in question. One route is direct investment. Many may find it interesting – even exciting – to do things this way and, considered as a hobby, this is perfectly reasonable.

But those with only limited expertise in financial markets should remember that picking stocks is a complex task. With this in mind, it makes sense to employ an expert.

Then there is the question of whether to go for a pooled or a segregated approach. Again, this is up to the client. However, it also depends on the size of the portfolio. If it is very large, a segregated portfolio can be viable; for smaller players a pooled fund makes more sense.

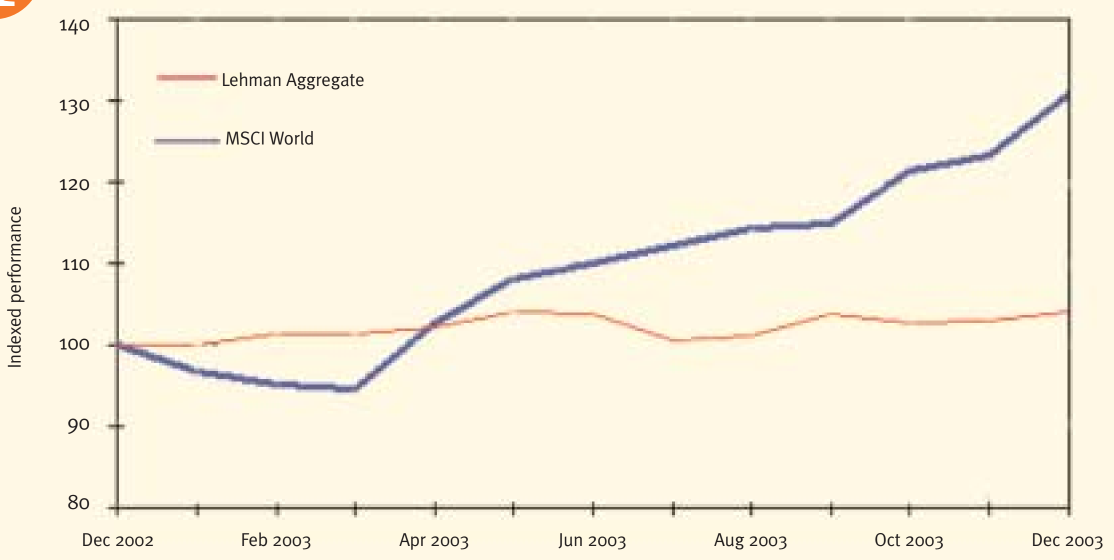
In employing a manager, a client can exert his own preferences as much, or as little, as he feels comfortable. Someone with strong ideas and confidence in his expertise regarding sector or regional allocation, can pick a fund accordingly; others can opt to leave such choices to the manager, invested in a global equities product.

In terms of investment style, the current climate favours a longer term growth approach to stock-picking. The emphasis is on quality – on companies with strong fundamentals, picked for sustainable growth potential, that are longer term winners.

Risk controls are crucial. They start at the company level, with careful analysis of stocks. The above style, of seeking companies with sustainable longer term quality and growth, lends itself to this kind of protective approach.

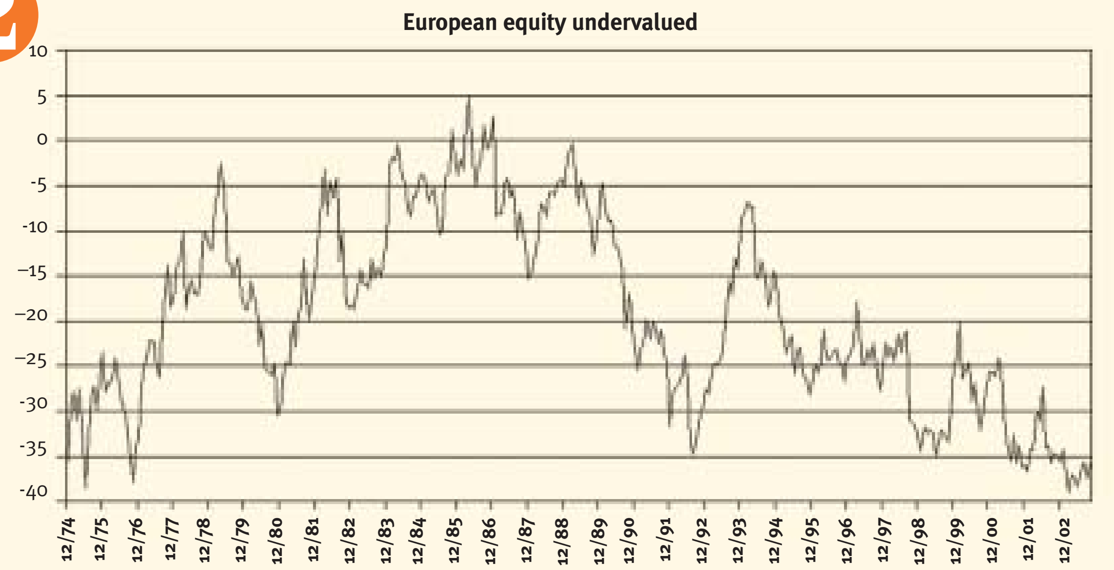
1

Fixed income trails equities: MSCI World versus Lehman Aggregate since April 2003



Source: ABN Amro

2



Note: MSCI Europe versus MSCI US (1974-2002). Average valuations across trailing P/BV, P/CE and dividend yields

Source: Morgan Stanley

However, risk controls also apply at the portfolio level. It makes sense to look at all the exposures to different factors – for example, exposure to the dollar in relation to the benchmark and exposure to oil prices.

More generally, an investor needs to start with a very clear view of his risk profile. Then the manager must calculate predicted tracking error relative to the benchmark, and keep controls in place to give a clear view of where the portfolio is relative to the investor's profile.

It should be apparent by now that choice of manager is crucial. The client needs to know what the risk profile on his portfolio is. It makes sense for him to select a manager whose way of working coincides with his own general beliefs.

How does the manager operate over time? What is his philosophy? Is there a benchmark or is he seeking absolute returns? What are the risk controls he has in place?

The HNWI, rendered wary by several stormy years, is finally preparing to step into the world of equities – a world newly calm but far from simple. It is imperative he knows what path he wants to take – and finds a manager who will stick to it.

Felix Lanters, head of European equity investments, ABN AMRO Asset Management