

## INVESTMENT UPDATE

5 October 2011

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### PERFORMANCE UPDATE

During September, the FTSE 100 fell from 5387 to 5128, a loss of 4.81%. Other stock markets fell further with the Hong Kong stock market falling by 19% in September, even gold fell by 11%. The “Broom Consultants” Cautious, Balanced and Adventurous Investment Strategies fell by 1.67%, 2.30% and 3.06% respectively.

Over the last year and since launch to the 5<sup>th</sup> October, our three investment strategies have performed as follows (the FTSE100 is in for comparative purposes):

	1 Year	Since launch
<b>Cautious</b>	- 1.39%	+ 4.14%
<b>Balanced</b>	- 1.80%	+ 7.25%
<b>Adventurous</b>	- 4.45%	+ 4.91%
<b>FTSE100</b>	- 4.41%	+ 4.83%

The graph below shows how the Broom Consultants Investment Strategies have fluctuated since launch and the table details the performance of our strategies compared to our benchmarks:

#### *Since Launch*



- A - Broom Consultants Balanced Portfolio 15/08/2011 TR in GB [7.25%]
- B - Broom Consultants Adventurous Portfolio 15/08/2011 TR in GB [4.91%]
- C - FTSE 100 TR in GB [4.83%]
- D - Broom Consultants Cautious Portfolio 15/08/2011 TR in GB [4.14%]

01/10/2009 - 05/10/2011 Data from FE 2011

#### *Various Time Periods*

	1 Month	1 Year	Since Launch
Broom Consultants - Cautious Portfolio	-1.67%	-1.39%	4.14%
Benchmark - Cautious	-0.95%	-1.62%	4.91%
Benchmark - Cash	0.14%	1.56%	2.91%
Broom Consultants - Balanced Portfolio	-2.03%	-1.80%	7.25%
Benchmark	-1.29%	-3.39%	3.04%
Broom Consultants - Adventurous Portfolio	-3.06%	-4.45%	4.91%
Benchmark	-1.61%	-3.78%	1.46%
<b>Average Outperformance</b>	-1.15%	0.20%	2.63%

The last three months has been a very turbulent and tough time for stock markets. The world's major stock markets have lost the following amounts:

UK FTSE 100	-13.74%
US S&P 500	-14.32%
German Dax	-25.39%
Indian Sensex	-13.29%
Hong Kong Hang Seng	-26.26%
Japan Nikkei 225	-13.49%

Even gold is only up 7.5% despite all the hysteria that has been written in the press about it. Whilst we do not enjoy telling you that you have lost any money, we are pleased that the losses on our portfolios have been minimised over the last three months, with our portfolios falling by:

Cautious	-3.60%
Balanced	-5.54%
Adventurous	-8.68%

The new Global Trend Fund (see article below) that will be launched shortly should assist us in future when we experience impending turbulent times. The three month outperformance of our portfolios versus their benchmarks, along with the approximate equity exposure we had in the portfolio on July 1<sup>st</sup> and the approximate exposure that we have now, is shown below:

**Cautious**

Equity exposure 1 <sup>st</sup> July	44%	Equity exposure now	29%
3 month outperformance	1.74%		

**Balanced**

Equity exposure 1 <sup>st</sup> July	54%	Equity exposure now	37%
3 month outperformance	4.72%		

**Adventurous**

Equity exposure 1 <sup>st</sup> July	80%	Equity exposure now	55%
3 month outperformance	4.63%		

**Over the last month, despite being underweight in equities, our investments in gold mining shares and our overweight exposure to Asian equities has meant that we have underperformed our benchmarks. However, we have substantially outperformed over the last 3 months and since launch.**

## THE EUROPEAN PROBLEM EXPLAINED (BRIEFLY!)

Investors have three main concerns that have caused stock markets to fall recently:

- 1/ The fear that the US (and other developed economies) may slip back into recession.
- 2/ The fear that emerging economies (especially China & India) do not grow as much as expected due to high inflation, which has meant that their central banks have raised interest rates to “cool” the economy
- 3/ The fear of a “European Banking Crisis” due to an un-orderly Greek default.

### The problem

In a nutshell Greece is bust. In early 2010, it was revealed that successive Greek governments had hidden its debts from EU overseers, in order to keep it in line with the euro monetary guidelines, so that by May 2010, public debt was one of the highest in the world at 120% of GDP. Since that date European politicians have largely been inept at dealing with the problem.

The history of the euro was that it was initially conceived for political and security reasons - mainly to end the centuries-long history of Europeans waging war with each other, so the economic convenience of a single currency was a secondary consideration, albeit not unrelated. Therefore the euro was always going to potentially cause enormous problems when member countries diverged economically from each other, like Germany and Greece are now.

Germany is the country that actually benefits most from the euro as it ensures that its huge export economy remains competitive. If it was not in the euro then its currency would be a lot more expensive and this would make the price of its goods i.e. BMW cars, more expensive for the rest of the world to buy. This in turn would lead to German companies making less profit. It is estimated that the cost of producing the same item is 30% more expensive in Greece than in Germany and this has therefore ensured that Greece is no longer competitive.

### What the solution would have been pre-euro

Previous economic problems in Greece and all over the world have largely been solved by weakening the currency. So for example, if Greece was not in the euro, it could devalue the drachma by 50% and become the number one European tourist destination in 2012. This would lead to a boom in tourism, tax receipts would roll in and the debt would be repaid. Unfortunately, Greece can not do this without leaving the euro. **The chances of this happening over the next year are slim as Greece still has a lot to gain short term from being in the euro.**

### The ultimate solution - fiscal union

Behind closed doors the politicians know what the solutions to the euro zone crisis are, but they have a problem in convincing their citizens to vote the solutions through. The ultimate solution is to replicate the UK and achieve fiscal union (but on a much grander scale). In the UK the vast amount of wealth is created in the south east (especially London) and this is distributed to other regions via the tax system. The solution is therefore to have a euro tax that taxes the prosperous northern European countries and redistributes the wealth to the poorer south. At the same time Greece sorts out its debt problems through austerity and by stamping out tax evasion.

Polls will show that the German public has reservations about the euro. However, overwhelming support for the single currency from Germany's powerful export industries and all of the country's viable political parties has seldom wavered. Last week German Chancellor Angela Merkel needed 311 votes in order to expand the European Financial Stability Facility's (EFSF) financial firepower. She received 523 and only 85 voted against. That is a resounding victory in favour of European solidarity and if the German Chancellor could persuade its voters that fiscal union was in their best interest then the solution would be passed. This is unlikely to happen at the moment.

## The short term solution

As fiscal union is unlikely to happen at the moment then a shorter term solution needs to be found. The short term solution is to build a "European Fund" that is big enough to bail out the European banking sector if (when) Greece defaults on its debt. This will ensure that we do not have another "Lehman" style crisis, in which banks stopped lending to each other and credit dried up. The "European Fund", called the EFSF bailout deal, would lend money to European banks and ensure that they remained solvent. Greece would then default or cut its debt by around half, giving it a chance to rebuild. Whether Greece remains in the euro after that will depend on whether it can put in place an austerity package that will substantially lower the rest of its debt. The bailout fund is not currently big enough to withstand a Greek default and the politicians are now working on increasing the size of it.

## What this means to your wealth

We feel that with the support of Germany, the euro will largely survive intact, but over the next few months and years the stock markets will be extremely unstable as it takes time to build the ultimate solution for the euro. The process will mean pain to the southern regions as wages are cut but also a period of low growth for the northern countries. The reason why stock markets fell over the last week is that Greece ran out of money at the end of the month and is relying on receiving a bailout package to see it through. Unfortunately it will only receive the bailout money if it achieves certain cost cutting measures, which this week has said it will not hit.

We have therefore positioned your portfolios more defensively than normal as you have a lot less in equities than the average investor. We have also not panicked completely and invested you 100% in cash, as some of the large multi-national companies are still performing well, even during a tough economic period. (See below about Coca-Cola). Therefore, we believe that it is sensible to keep some of your wealth in equities but also to protect you in more defensive asset classes like inflation-linked government bonds and emerging market bonds. We may, of course, recommend changing the balance at any time so please keep checking your emails.

Within equities we prefer the defensive equity funds that invest predominantly in big multi-national companies that are generating lots of cash. Below is an example of one such company, Coca-Cola, and you can see how it has been unaffected by the recent problems:



**Some of the defensive equity funds you are invested in have actually produced a positive return over the last year with the Invesco Perpetual High Income Fund growing by 5.16%, despite the FTSE100 falling. Please remember that when you invest in equities you are investing in companies and not economies.**

## Commodity update

In last month's update we wrote:

*"What is particularly worrying is that rice, which is the staple food for half the world's population, is beginning to go up in price again. Rising food prices were arguably the trigger for the recent Arab uprising. If the prices of these commodities fall in the short term, then interest rates in the emerging markets could fall and this would probably trigger a bounce in stock markets. Interest rates in India are 9% and inflation is up at 9.44%, which is a huge concern. Only when inflation begins to fall, then interest rates can come down and stock markets could make further long-term gains.*

*Therefore, by monitoring the prices of these commodities we can get a better indication of when the next possible long term bull market will commence."*

During September, the prices of the "important" commodities fell back as you can see from the charts below. This could mean we are at the start of the cycle discussed above and this could provide us with an opportunity to increase exposure to Asian equities. It also makes us wary of investing in commodity producing countries such as Brazil and Australia.

### Oil



### Copper



### Corn



### Rice



Unfortunately, over the month gold also fell and this led to losses in our gold related investment, with the Blackrock Gold & General fund falling 11%. This did not help our portfolios but we remain invested in the fund as the price of gold is still on its bull trend.

## **THE NEW GLOBAL TREND FUND**

Our investment philosophy can be summarised as trying to invest more of your wealth in asset classes that are on rising trends and less of your wealth in asset classes in trends that are falling.

The strategy works extremely well over the long term but the speed of recent movements in the markets created a situation where we were slowed down when processing portfolio switch recommendations as we needed to wait for your consent before we could action the switch.

Many of our clients requested that we act automatically on their behalf to allow the changes to be made with greater speed but we are not authorised to change the funds in your portfolio, including adjusting the percentage of each fund held, without your express consent.

However the composition of any given fund within your portfolio can be changed by the individual fund manager as and when felt necessary without requiring client agreement. Therefore, in response to your feedback and in order to allow the Broom Consultants Wealth Management Service investment team to reduce the effect of the delays we have recently experienced, we are introducing the new "Global Trend Fund".

This fund will allow us to adjust your exposure to an asset class held within it as soon as movements demand, i.e. exposure to falling markets can be reduced automatically, We propose initially to invest around 30% of your wealth into the new fund when it is launched and this will act as our asset allocation "valve" and ensure that we can increase/reduce exposure to different asset classes much more quickly.

The Global Trend Fund will complement the other funds held in your existing portfolio extremely well as you will retain your investments with some of the UK's leading fund managers, whilst having the extra reassurance that in difficult times we can reduce the risk of your portfolio fast and efficiently.

The most important change is that we will not require agreement from you for each adjustment within the Global Trend Fund. However, you will still be sent switch recommendations in the usual way, which you need to respond to, whenever we recommend a change to the other funds in your portfolio or an adjustment to the percentage of your portfolio held in the Global Trend Fund.

We will shortly be contacting you with more detailed information on the new fund so please watch this space!

## **WHAT RISK ARE YOU TAKING WITH YOUR MONEY?**

One of the most important factors that affect the returns on your portfolio is the risk that you are taking. Our objective is to reduce the risk of your portfolio during the bad times and increase it during the good times so that we protect your wealth in the bad investment periods and you remain invested and benefit from the good investment periods. If this is achieved successfully then the overall risk to your portfolio will reduce and your losses will be minimised during the bad times.

But how do we measure the risk that you are taking?

The best measure is something called volatility. This is simply a measure of how much your portfolio moves on a daily/weekly basis. For example, if a portfolio grows by 10% in a month and then falls by 5% the next it is much more volatile than a portfolio that grows by 2.5% in each of the two months. Most investors would prefer to be in the second portfolio as the returns are the same but the risk is much less. The objective of managing a portfolio is therefore to maximise returns but minimise the volatility (risk).

So what are the risks of our portfolios?

We use the annual and 3-year volatility as our preferred measures and the higher it is then the more risky the portfolio is. The table below shows the volatility of each of Broom Consultant's portfolios against the average fund:

<b>Broom Consultant's Investment Portfolios</b>	<b>Volatility</b>	<b>Benchmark Funds</b>	<b>Volatility</b>
Cautious	4.97	Average Cautious	5.48
Balanced	6.62	Average Balanced	8.80
Adventurous	9.04	Average Adventurous	10.66

By comparison, the UK Stock Market FTSE 100 has a volatility of 13.21 and Emerging Market Equities has a volatility of 17.12.

**As you can see all of our portfolios are currently experiencing a lower risk than their benchmarks.**

## SUMMARY

The news flow especially on Europe has been extremely negative. If you read any of the newspapers then you would be led to believe that stock markets are down 80% over the last few months as only the negative news has been reported and the days when the stock markets have bounced upwards have been omitted. What we do know is that this volatility will remain for the foreseeable future and large gains and losses can be made over the next few months/year. We have positioned your portfolios more cautiously than normal and may make them even more cautious than normal over the next few weeks/months.

Please remember that stock markets only fall when bad news gets worse and some of the bad economic headlines that we are reading about have actually led to stock markets bouncing as the news was not as bad as expected.

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