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Recent Events in Financial Markets

Following the recent unprecedented events in financial markets, I thought it would be helpful to set out our position and how the current financial climate is affecting the way in which we manage client portfolios. The coverage of these events in the press has been very comprehensive, but has left many clients asking: what does this mean for me?

What has happened? Over the weekend the US authorities chose not to provide financial support for Lehman Brothers, a large US investment bank. This represents the culmination of a series of events in which it had been hoped a buyer could have been found for the ailing business. In simple terms, the bank got into trouble as a consequence of investing too much capital in complex securities whose value is tied to the US housing market. As house prices have come under pressure, the losses at Lehman have been unsustainable. At the same time, the stock market has been placing pressure on the shares of Merrill Lynch, for similar reasons, but this firm has been rescued by Bank of America.

In contrast, the authorities have chosen to stand behind American International Group's liabilities, once it became apparent that it was unable to shore up its balance sheet via the capital markets. Simplistically, the problem for AIG is effectively that it has sold insurance to other investors to protect them from the downturn in a range of asset classes - particularly the US housing market. It now faces large losses, as a consequence. In the UK, in spite of a recent capital raising, HBOS looks likely to be driven by share price weakness into the arms of Lloyds TSB, or even a government-sponsored rescue.

On a positive note, the Federal Reserve Board has moved to make cash available and has helped form a fund of $70bn, backed by ten large banks, to ease the potential problems in the system.

Whilst the images on News at Ten of Lehman employees carrying cardboard boxes from their offices in Canary Wharf have been striking and the coverage a little 'breathless', the content has been mostly accurate.

Nonetheless, these are events that we did not foresee and the issue, for long-term investors, such as ourselves, is what these events might mean. The very obvious knee-jerk response from the market has been for share prices to be marked down: the FTSE 100 Index duly fell 3.9% on Monday and 3.4% on Tuesday. Our clients' portfolios are, in large part, invested in equities and will not have remained unaffected. However, in this climate, it is important to remember that the perspective of most market 'players' is measured in hours and, therefore, much shorter than would be appropriate for our clients' portfolios.

If history can be a guide, then the first, emotional responses to such news are usually wrong. At times such as these I think back to Black Monday in 1987. For days following this event, prices bore little relation to reality, but by the end of the year had seen a significant recovery. The current environment is certainly challenging and clouded by the uncertainty many feel about how other financial institutions may be affected by the 'unwinding' of Lehman Brothers' and AIG's outstanding liabilities.

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In our Strategy Meeting, on Monday morning, we reviewed both the short and the long-term view. The near term is going to see continued volatility - the current mood of investors is nervous. However, we also concluded that in this dizzy climate, share prices are being fundamentally undervalued. What does that mean?

The value of a share (or a company, if you like) is surely only a function of the cash it can deliver to you in the form of dividends. So, for any investment, you have two simple questions to answer: what is the dividend yield and how likely is it to be paid? For client portfolios, we see plenty of shares where the dividend yield is historically attractive and where the dividend is very likely to be paid. In theory, one should just be able to wait for the value in those shares to be recognised, when others stop panicking. The question is, when will that happen?

Aside from the US housing market, one of the big worries facing consumers and investors has been inflation - in metals, food and energy prices. However, in the midst of this panic, the recent dramatic fall in oil, wheat, corn, soya beans and industrial metals seems to have gone unnoticed. Potentially, with this problem behind us, consumers will feel more confident and central bankers can be expected to cut official interest rates sharply. These are the catalysts for a recovery that, amidst all the noise, we believe are slowly falling into place.

The coming weeks and months, then, will be challenging for all of us. The key, in managing client portfolios, is not to be swept along by emotion, but to look for the opportunity to do the opposite of the crowd. Of course, sometimes, that will mean doing nothing while others chase the latest rumour!

Charles WD Brand
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