

## When will confidence return?

As markets record some of the sharpest drops in history, investors could be forgiven for wondering if there is one single factor that would shore up confidence in the markets and alter their direction. In a normal year, for example, markets may respond to inflation, interest rate expectations, consumer sentiment or corporate earnings. But this is not a normal year. This year, liquidity has become the force that drives everything else.

To recap, worries over hidden toxic debt have left banks mistrustful of the creditworthiness of other banks. Given that much of the financial system relies on banks being willing to lend to other banks, this has created the contraction in available funding that has led to such volatility in markets.

The repercussions of this lack of available credit have been widespread – individuals have struggled to remortgage and have often found themselves paying significantly higher interest rates. Equally, they have been unable to borrow as much money with banks now rejecting huge numbers of mortgage applications. This has put pressure on the housing market, which is now seeing double-digit falls.

Companies have seen similar problems. Those companies that have had to rearrange existing debt have seen their repayments soar. In some cases, banks have been

unwilling to lend at all and the company has gone bust. In turn, revenues have come under pressure as individual and corporate income has weakened. This has seen certain sectors hit particularly badly – notably retailers.

The recent actions of the US Federal Reserve and other central banks to shore up the banking sector have focused on both pulling the remaining toxic assets out of the system and guaranteeing deposits to restore confidence. Central bankers are attempting a similar trick with aggressive cuts in interest rates. So far, this has not had the intended effect on the inter-bank lending rate, which remains significantly higher than base rates, though it has seen a small drop in recent weeks.

Stockmarkets remain unconvinced the actions of governments and central banks will be effective. They are likely to remain weak until they receive some sign of confidence returning to the banking system – with evidence banks are willing to lend to each other. Only when the Libor inter-bank lending rate begins to drop to meet base rates and money markets start to function once again will the markets turn their attention away from liquidity concerns to economic and stock-specific factors.



Welcome to the latest edition of e-Update, our update on developments in the world of financial services. We hope you find the contents of interest. If you have any questions, or would like to discuss any of the points raised, please give me a call.

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## Survive the Recession...

### NO 1: DIVERSIFY

This is also the first rule of investing but worth reaffirming. Different asset classes perform well or poorly at different times. If your portfolio is exposed to a single asset class – say, equities – its performance will follow the fortunes of only the equity market, and returns will be volatile. However, if your portfolio contains a selection of different asset classes, and is also spread across different countries and regions of the world, the different elements will perform differently – so if one is doing badly, the chances are another will do better and compensate for some of the downside.

## Hedging your bets

The thought of a fund that might deliver positive returns despite falling markets is very appealing, but is it actually possible? This is the potential being offered by ‘absolute return’ funds which reckon they can beat cash and smooth out market returns.

They use a variety of different techniques. One, the multi-asset strategy, blends asset classes like equities and bonds with alternatives such as hedge funds or gold. Therefore, when the mainstream asset classes are losing money, these managers have the opportunity to invest in alternatives delivering positive returns. The other main strategy uses ‘hedging’, ie: invest purely in equities, but ‘short’ some of those stocks. This involves borrowing them from someone else, selling them and then buying them back at a later date. There is a small price for borrowing but if the market moves down, the manager buys back the stock at a lower price than it was sold, making a profit in the turnover. This acts like an insurance policy, repaying some of the loss made on the fund holdings which will have fallen with the market over the same period.

Whichever approach is taken, the result should be smoother returns. However, neither should they be seen as a panacea. Diversity is a good thing but a manager still has to make choices – and can make the wrong ones. Shorting stock is a particular skill and could even increase losses. So, despite the label ‘Absolute return’, always remember that this is an objective only; there are no guarantees.

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## What is a SIPP?

The popularity of the Self-Invested Personal Pension (SIPP) has increased dramatically in recent years. Costs have come down, many investment providers have launched SIPP-friendly products, and the UK government has ensured many different types of investments qualify for inclusion in a SIPP wrapper.

A SIPP is a tax-efficient wrapper – a particular type of pension – which sits around your retirement fund, allowing you to select from a wide range of investment choices. It gives you great control and flexibility over the investments, allowing you to tailor your SIPP portfolio to match your investment requirements. If you are employed, your employer can also pay into the plan to help boost its value. All contributions, within preset annual and lifetime limits, receive income tax relief at your highest rate, and all investments within it will not be liable to any further income or capital gains tax (CGT).

A SIPP also allows flexibility once you reach retirement, whether you buy an annuity immediately or opt for phased or deferred retirement. However, while there are long-term benefits for those interested in the flexibility, they are not for everyone. There are set-up charges, and annual management charges which need to be weighed up against the benefits. You will also need to consider whether you need the full investment flexibility provided by a SIPP or whether the increasing range of fund links offered by more conventional plans would actually be sufficient.

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