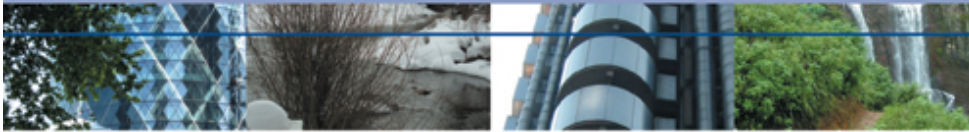


News & Views



Winter 2008/2009

Return to confidence

In a normal year, 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. Worries over hidden toxic debt have left banks mistrustful of other banks. Given that much of the financial system relies on banks being willing to lend to each other, this has created a contraction in available funding and led to huge volatility in markets.

The repercussions have been widespread: individuals have struggled to remortgage or have simply been unable to borrow at all. Banks are rejecting huge numbers of mortgage applications and this has put pressure on the housing market, which has seen double-digit falls on the year.

Companies have experienced similar problems. Those that have had to rearrange debt have seen repayments soar. In some cases, banks have been unwilling to lend at all, meaning companies have gone bust. In turn, revenues have come under pressure as individual and corporate income has weakened.

Stockmarkets are likely to remain weak until they see some sign of confidence returning to the banking system and some evidence of a willingness to lend again. Only when the Libor inter-bank lending rate begins to fall back towards base rates and money markets begin to function once again will the markets turn their attention back to more discerning economic and stock-specific factors.

Investment bonds

Investment bonds are tax wrappers offered by life companies that give you a choice of how money within them is invested. The most popular funds used to be with-profits, managed and distribution funds, which combine different assets within one fund. Today, however, more options are available, as life companies also offer external links to fund management houses, increasing the opportunity to mix and match. Onshore bond funds automatically pay tax on the income and gains internally and this is deemed equivalent to the savings rate of income tax. Basic rate taxpayers therefore pay nothing more on their profits and higher rate taxpayers pay just another 20%.

Welcome to Rutland Investment Managers latest edition of News & Views, our update on developments in the world's stockmarkets.

If you would like to discuss any of the issues raised in this newsletter, please do not hesitate to give us a call.

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A delicate balance

Even in January 2008, the Bank of England acknowledged it could be a tough year for the UK economy, forecasting a consumer slowdown as people cut back on spending. This led to expectations of an interest rate cut yet high fuel prices also pointed to a period of above-target inflation. The Bank's dilemma was that, if it eased rates, it could fuel inflation – but if rates were kept steady, the prospects for economic growth were suppressed. Ultimately the Bank emphatically chose the former course of action but, ironically now faces the spectre of deflation – a different set of considerations but the same balancing act.

Hedging your bets

As equity and bond markets have become increasingly unpredictable, the thought of a fund that might deliver positive returns year after year has become even more appealing. The result is a new breed of 'absolute return' funds which, while they do not come with any guarantees, set out to beat the returns on cash AND avoid the fluctuations of the markets.

This new generation of funds is quite sophisticated and uses a variety of different techniques to achieve their goals. One of the most popular is the multi-asset strategy which blends traditional asset classes like equities and bonds with alternative asset classes such as hedge funds, gold or private equity. In times like now, when the mainstream asset classes are volatile or losing money, these managers at least have the opportunity to invest in assets delivering positive returns.

The other popular technique is to invest purely in equities, but to 'short' some of those stocks as well – ie: borrow more stock from someone else, sell it and then buy it 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, thereby making a profit in the turnover. This acts like an insurance policy, counteracting some of the loss made on the actual fund holdings which will have fallen over the same period.

When you short stock you own, this is called 'hedging', allowing a manager to make some money whichever way the market goes – profiting on their actual holdings if it moves up and profiting on the borrowed stocks if it moves down. Overall, if the market moves up you profit a little less because of the payment made to borrow stock and the increment in cost to buy it back. However, if it moves down, you lose out less because the insurance policy of shorting balances some of it out. The result is smoother returns with lower peaks but also fewer shocks.

This approach looks set to be the focus for imminent new launches in the absolute return arena, but it is no panacea. Shorting stock is a particular skill and in the wrong hands can perform just as badly as, and sometimes even worse than, a traditional equity investment. So, despite the label 'Absolute', always remember that this is an objective rather than a guarantee. These funds are not suitable if you cannot take the risk of losing capital. However, managed well, they could represent an exciting alternative to traditional equity and bond funds for investors seeking smoother market returns.



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