Volatility... an opportunity or a threat?

If America sneezes, we all catch a cold: what happens when the US is shivering? We take a look at volatility and how to minimise its impact.

The market correction that had been talked about for many months was eventually played out over the summer, thanks primarily to the US sub-prime mortgage crisis. The Americans' eagerness to lend money for mortgages to those who can ill afford to pay them back sent global markets into a spin. The Federal Reserve became so worried it hastily reduced the discount rate it charges to banks as it attempted to restore orderly conditions to the financial markets. The full effect and impact on corporate earnings is yet to be borne out as financial institutions hastily calculate and review their financial exposure.

We should not lose sight of the fact that sub-prime lending is not solely a US issue – the UK itself offers these types of arrangements – but here the Financial Services Authority (the regulatory body) safeguards our interests by closely monitoring the providers. However, although the media circus had initially focused on the US, due to the very nature of how major financial markets and institutions work – buying and loaning credit/debt to each other – the full impact has now started to be played out, right in front of our eyes. Northern Rock became the first major casualty – due to its inability to raise liquidity through its normal practices – requiring the intervention of the Government and the Bank of England to help quell overwhelming public concern as money was withdrawn at alarming rates.

For individual investors, the primary concern is whether a company in which they have invested is actually financially exposed to the sub-prime debacle.

So should investors be concerned about the dramatic one day FTSE swings we witnessed this summer? Not necessarily; history has clearly demonstrated that markets are always susceptible to correction and it is only through the power of the media and sensational headlines such as 'Today the market fell by…' that we are led to believe these movements are creating total meltdown within the financial markets. And it's the bad news we notice and remember. Throughout the summer, the markets have depicted the ride of a rollercoaster, with large negative downward swoops, followed swiftly by a rapid climb. But is that how the investor in the street remembers it? At the lowest point in the summer, the market had simply lost all of the gains realised since September 2006. Not ideal, but again it's easy to forget the preceding 4 years of positive gains and the upward trend since August of this year.

"Volatility is a common occurrence within global stock markets – it's how investors deal with it that matters."

Volatility is a common occurrence within global stock markets – it's how investors deal with it that matters. All too often, investors observe the general herd mentality and follow the leader. But, just because the large financial institutions start selling, should private investors follow suit? What would you do if you knew they were actively buying? There is no right answer – the decision needs to be thought through in light of your own investment objectives and risk preferences. Do you need to sell? Do you need to buy? What are the financial objectives? What are the time horizons? It's always worth remembering that in times of a downward spiralling market, there will still be investors happy to invest, taking advantage of weaker prices.

Large financial institutions have a variety of reasons for buying or selling in a volatile market. Fund managers may have already realised sufficient value from an investment or believe there is greater value still to be found in a weaker share price. Regardless, fund managers will always look to generate the greatest returns possible given their own or their fund house's investment policy. Historic fund performance is a track record that all fund managers and fund houses like to remind investors of – albeit with the caveat of past performance being no guarantee to future performance.

To help minimise the impact on a portfolio in times of volatility, investors can employ a variety of strategies, aimed at helping reduce risk and exposure. Take a look at our article in this issue that explores the research and monitoring tools on our website and explains how to use limits to minimise risk.

Pound cost averaging can help take the edge off your long term exposure to market risk. It is an approach to investing rather than an actual investment: instead of investing all your capital as one lump sum, payments are 'drip fed' in, over a period of time. As each contribution is made, an appropriate number of shares or units are purchased and over time, this has the effect of averaging out the purchase price. If the price is rising, your contribution will purchase fewer shares/units than average, but in times of volatility, your purchasing power is maximised and a larger than average number of shares/units will be purchased, taking advantage of weaker prices. Our

Regular Investment Plan takes advantage of this approach and as we've just reduced our commission charge on this type of plan it's a good time to consider it.

Certain 'defensive' sectors have historically shown themselves to be less susceptible to market turbulence than others. When the markets start to tumble, investors often switch to investments in the Pharmaceutical, Tobacco and Utilities industries. Companies within these sectors have proved over time that they can withstand the vigorous price movements seen elsewhere and generally offer a balance between income and growth.

Exchange Traded Funds (ETFs) are still relatively new to the vast majority of UK investors. ETFs are structured like Tracker Funds, but typically enjoy lower management charges. They allow investment risk to be spread across an entire market or sector, but have the added bonus of being actively traded – like any standard share – on the stock exchange throughout the trading day.

Also included in this issue are the prevailing views of experts from within The City who share with us their outlook for the future and their actions and equity selection techniques during times of uncertainty. And don't forget that The Share Centre Advice Team is only a call or a click away.

At a glance

Sub-prime lending sends global markets reeling.

There are always investors happy to take advantage of weaker prices.

Defensive sectors are less susceptible to market turbulence.

Pound cost averaging can reduce market risk.

ETFs spread investment risk.

Graham Spooner
Investment Adviser,
The Share Centre

Here to help you...

Graham started his career in 1977 at Simon & Coates as a 'blue button' (trainee dealer) on the Stock Exchange trading floor. Two years later, he became a fully authorised dealer and stayed on the floor until the 'Big Bang' in October 1986. His career as a dealer continued at Chase Manhattan Bank, Svenska Bank and Midland Bank before he moved to emerging-markets specialists, City of London Investment Management, where he helped develop their international fund management business. His 30 year exposure to dealing, fund management and customer liaison have given him a variety of perspectives on market influences and positioned him as a valuable asset to an advice team.

Graham joined The Share Centre in 2001 as an FSA approved investment adviser. He advises on a range of The Share Centre's investment services including UK Equities and Investment Trusts. In addition to phone support, Graham provides advice to The Share Centre's customers through other forums, e.g. investment club meetings.

A respected voice in the media, Graham's comments on the markets and share tips are frequently sought by The Times and the weekend editions of The Telegraph. He has also contributed advice and articles to The Guardian and Bloomberg Money, amongst others, and participated in Radio 2 and Independent Radio News broadcasts.

Graham's advice and skills are not limited to share selection. As an integral member of the Stock Exchange Cricket Club, he regularly bats it out against other major UK financial institutions and has represented the club in three major tours of Hong Kong and Singapore, Australia and South Africa. Closer to home, he manages a local Colts cricket team and plays competitive table tennis.

Graham and other members of the Advice Team can be contacted on 01296 41 43 45.