

# How global events affect your investments...

## and how you can build a Beta portfolio.

In February, stockmarkets around the world were shaken when share-trading reforms in China sparked a 9% fall in one day. The worldwide reaction to a very local phenomenon served as a sharp reminder about the truly global nature of finance and financial markets. Money flows from city to city on screens and through wires; in crates of goods on ships (increasingly from China); in oil pipelines across the Siberian wilderness, through hedge funds and futures contracts and via a host of investment devices barely imaginable twenty years ago.

This global market gives investors unique opportunities for profit, and fuels market growth of the kind that UK investors have enjoyed since 2003. But it presents its own problems too. As Shanghai's stutter made all too clear, the interconnected nature of global finance means that if there is a problem in one place, the pain can be felt everywhere.

The sums involved in global finance are staggering. US bank Bear Stearns has just announced a £1.6bn bailout for one of its hedge funds exposed to this market. Hedge funds borrow to make their 'bets', so if a fund fails someone, somewhere else is left with a bad debt. Often these debts take the form of derivatives contracts. The amount of money involved is enormous. At the end of 2001, outstanding issues of just one class of derivative (the swap) had a notional value of \$59 trillion, or \$10,000 for every person on Earth. These instruments almost resulted in a global financial meltdown in 1998, as US hedge fund LTCM's collapse was precipitated by a run on the rouble in Russia – another combination of local events whose effect was felt across the globe.

This issue of The Shareholder focuses on the opportunities and threats of the

situations in various key regions. It is certainly an interesting time to be an investor. In China, the general public is pouring its life savings into the new pastime of investing and pushing the Shanghai stock exchange to dangerous highs. In May the Shanghai Composite passed 4,000, having broken the 3,000 barrier only three weeks earlier, despite the authorities' efforts to cool speculative excitement. As we go to press it stands at 3865.72.

**This global market gives investors unique opportunities for profit, and fuels market growth of the kind that UK investors have enjoyed since 2003. But it presents its own problems too.**

In Russia, the Kremlin appears to be embarking on an aggressive programme of recapturing national assets. In a world of increasingly scarce energy sources, those states that do control it can exercise a malevolent influence; Russia's posturing appears tame compared to that of Iran, as it develops nuclear technology in the face of international opposition. Here too the knock-on effects persist far beyond the local. The US has lighted on bio-fuels as a means of reducing its political dependence on the Middle East and Iran, only to see corn prices shoot upwards, leading to riots in Mexico as basic food costs doubled.

Closer to home we face uncertainties too. We have a new Prime Minister and new administration which is as yet to show its hand. We are potentially facing interest rates of 6% by the end of the year as the Bank of England attempts to slow inflation. Higher interest rates lead to a strong pound, and a strong pound seriously damages Britain's capacity as an exporter of goods and services. Higher interest rates (and yields in bond markets) also tempt investors out of equities and drag the index downwards: this is exactly what happened in Wall Street in mid June, leading some commentators to call it the end of the FTSE's long rally.

Investing successfully in such complex and uncertain times appears a daunting task, although as this issue makes clear, the rewards are there for those who try. The answer is to make use of the most basic of investing tools, the portfolio.

### The measure of a portfolio

Many investors fail to realise just how useful (and simple) the 'portfolio' is as a tool for risk management. By spreading your assets across different classes you mitigate the effects of changes in individual components.

The first step is to decide on your risk preference. Those who are risk-averse should hold a substantial portion of their portfolio in cash or UK gilts (which can be bought through your account with us), or perhaps a fixed income managed fund. But with inflation threatening these investments, it is important to keep some equities too. Those with a higher risk tolerance should keep most of their money in the market.

Then think about how you spread your market investments. Finance theory says the risk attached to an individual share



## At a glance

Trade in goods, services and finance is truly global.

Different issues affect different regions in different ways.

You need to understand what the companies in which you invest do, and where they operate.

A portfolio approach to investing helps balance different risks.

Individual shares are affected by both 'general' and 'particular' risks.

Compare 'beta' factors to assess relative risk levels.

can be broken into two kinds: 'general risk', the part relating to global considerations such as energy shocks, currency movements, tariffs, political instability and even war, and the 'particular risk' attached to each company relating to poor trading, industry downturns, or even sudden collapse. Around 30% of the risk attached to any share relates to the 'general risk' with the remaining 70% attached to 'particular risk'.

The good news is that you can eliminate much of your exposure to a particular risk by building a diversified share portfolio. While the return from the portfolio is the average of all individual returns, the overall risk diminishes with every additional share: as a rule of thumb, an investor with 12 shares spread across different sectors will have diversified away some 90% of the 'particular risk'.

That leaves you with the question of how to deal with the 'general risk' aspects—the real nasties – banking collapses, bond market runs, the kind of thing that will send every share on the market heading downwards.

There is, fortunately, a relatively straightforward way of dealing with this. While economic booms and systematic shocks affect the whole index, some

shares will be affected more than others. Some companies tend to perform better than the market in good times and fall more quickly in bad, while others fall behind the market as it rises, but hold their value better when it drops. This propensity to move is measured by the figure 'Beta'; the market as a whole has a Beta of 1, a higher figure means riskier shares (aggressive) while a lower score indicated less risky (defensive) shares.

A risk-friendly investor who expects the market to rise should own more aggressive shares, such as those in the Mining, Life Insurance and Financial sectors, and fewer defensive shares; a more risk-averse investor, concerned about possibility of falls, should have a more defensively-based portfolio, such as Utilities, Banks and Tobacco companies.

When you next look at a company information page using the Company Search facility on share.com, click on the tab marked 'Prices' and you'll see the company's Beta rating. At the time of writing, the most defensive shares (with the lowest Beta) in the Index were BSKyB, Associated British Foods, Cadbury Schweppes, HSBC, British American Tobacco and Diageo, all around 0.6. The highest Betas were the mining companies, with Anglo American

and Xstrata scoring around 2.05.

This means that for every ten points the market moves, BSKyB is likely to move only 6, while Anglo American would move around 20.5.

You can use this information to build a better-shaped portfolio. At one end of the scale, twelve or more shares each with a low Beta and in different sectors can help you ride out the storms the markets throw up. At the other end, high Beta shares will tap into the growth opportunities as the market runs upwards. In all probability you'll position your portfolio somewhere along this scale. Of course, Beta is not the only financial measure available, but in terms of risk management it is the most important. In a complicated world, Beta is an investor's friend.