

Fundamentals

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Volatility is a word that now appears in many investment reports. But, while it describes the current challenge of the stockmarket, at the same time it does not tell the whole story. This year, share price volatility has combined with a strong downward trend in markets. Investors need to know why this is happening, and if it means the nature of their investments has changed. Extreme daily stockmarket moves raise questions about investment in shares. Should investors rebalance their overall portfolios?

With big month-by-month variations, it has also become harder to assess investment performance. Amidst thin trading volumes in the summer, shares reversed the performance patterns of the previous twelve months. The August bounce in share prices – in particular financials – was of low quality with little fundamental news. Typically, prudent managers with low exposure to the more volatile areas of the stockmarket missed out.

The sharp rally was triggered by intervention from the US authorities, apparently targeted at maximising the impact of their intervention. News was not only brought out against a background of light trading, but announcements on Sundays appeared to encourage rallies initially in Far Eastern markets. This forced hedge funds and other traders to close positions as soon as European and US markets opened. In this way, action by the US SEC seemed both to exploit volatility and to increase it.

Now, in September, this has moved into reverse. Bad news emerging over weekends can set downward trends in place before the New York market opens. Volatility ripples from one stockmarket to another. The interconnectedness of global markets and economies requires more frequent and timely company reporting. Fear feeds on a news vacuum. With nothing proven by regulators about bank rumours and hedge fund trading in March, it will be doubly difficult to tackle the new fears that are emerging.

Volatility is often dismissed as reflecting investors' lack of conviction in underlying

values. Yet the fact is that the real value of shares in some companies can swing widely, if they have little room for error in their balance sheets. For example, bad weather in August would usually have little impact on most pub chains, but some now have high borrowings and are much more vulnerable. The best way for companies to stabilise share prices and address stockmarket fears is to provide the facts.

Unfortunately, some company problems have been identified by sharp investment analysts before management has informed shareholders. It seems that economic turbulence and a rapidly changing outlook for companies is feeding share volatility. The right response to falling share prices is not an attack on investment managers and hedge funds, but candour from company boards.

The merits of equity investment have not changed, but investors need a time horizon that spans at least one stockmarket cycle. Surprisingly, although volatility is currently high, the trend in recent years has been of a reduction. This is despite the increasing synchronisation of the global economy. In the coming months, volatility should decline. However, companies and regulators have a part to play in achieving this.

As company reporting picks up in October, it will become clearer whether companies are valued correctly. Shares have not changed, and investors should not be unsettled by short term share price moves.

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