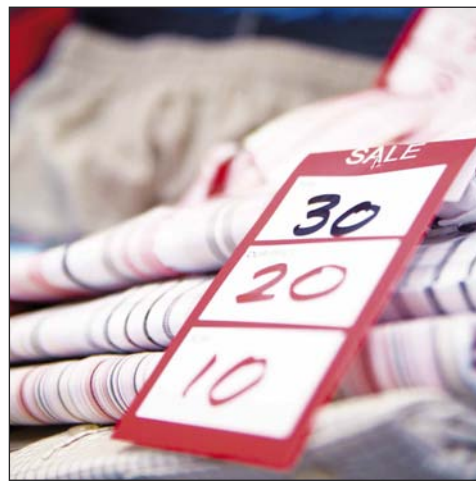


# Coping with the Credit Crunch

One year after the 'credit crunch' rocked global investment markets, what are the long-term implications for you as an investor, and what should you do now?



## How did the credit crunch begin?

Problems first surfaced in the US last year, when the consequences of an over-inflated housing market, and cheap mortgage loans to high-risk ('sub prime') homebuyers, began to have a damaging effect on the US economy. More and more homebuyers defaulted on their loans, which put the mortgage lenders into difficulty. It was also revealed that these lenders had sold on large portions of their loan books to other financial institutions ('securitisations'), spreading the problem worldwide as these assets rapidly dropped in value.

Because of these 'toxic' investments, and the fear of being left holding worthless assets, banks became increasingly unwilling to lend money to each other. Labelled as a credit 'crunch', the lack of lending quickly blocked up the banking system, the lifeblood of investment markets worldwide. As a result, the share prices of financial institutions started to fall rapidly. The US investment bank Bear Stearns, possibly the highest-profile casualty of the crunch in the US, collapsed because of doubts about its ability to carry out its day to day business, and the problems from the US spread quickly overseas.

## A Rock in a hard place

In August last year it was revealed that the mortgage and savings bank Northern Rock had applied to the Bank of England for an emergency loan. Northern Rock, which funded most of its business by borrowing money from other institutions, had been suffering more than other UK banks because of the crunch.

When the application for emergency funding became widely known, the bank's share price dropped rapidly, and people began queuing to withdraw their savings. The bank's fear of lending to each other had now spread to the high street. Despite assurances from the Government that Northern Rock's customers' money was safe, the damage to the banks reputation had already been done, and it was nationalised by the Government in February 2008.



Photo: Dominic, [www.mymv.co.uk](http://www.mymv.co.uk)

**“ This crisis is deeply rooted in fears of insolvency of major financial institutions ”**

*Alan Greenspan*

*(former US Federal Reserve Chairman)*

## Calling time on cheap home loans

1. After several years of prosperity and low interest rates, mortgages, credit cards and personal loans had become very cheap and easy to obtain.
2. In the US, mortgage-owners were encouraged to re-mortgage to solve their financial difficulties, and to keep spending.
3. Once US interest rates started to rise (from 1.0% in 2004 to 5.35% in 2006) homeowners couldn't afford their repayments and started to default on their loans.
4. This left some banks in financial difficulty, and the housing market began to slump, as the supply of houses began to significantly outstrip demand.
5. The problem spread to the UK, with greatly reduced mortgage approval numbers and falling house prices.



### What impact has the credit crunch had?

As Northern Rock demonstrated, when investor decisions are driven by fear, a company's share price can descend rapidly. Sometimes, a single event can drive economies into a serious downturn. The crunch caused extreme uncertainty in financial markets throughout the world, as prominent and highly profitable financial institutions such as JP Morgan, UBS, Credit Suisse, and others all announced significant write-downs in the value of their assets. Also this year, the price of oil has risen to record highs, and food and fuel price inflation is causing considerable discomfort for large sections of the population in the UK.

#### The impact for companies:

- Economic activity slows
- Productivity drops
- Companies cutting back on spending
- Job cuts announced

#### The impact for consumers:

- Credit harder to obtain
- Consumers avoid large purchases
- Housing market slumps
- Unemployment increases

# What does it mean for you as an investor?

It is worth keeping the current 'crisis' in perspective. Over the years there have been several periods of market difficulty, when stockmarket valuations have taken a sharp fall before returning to more reasonable levels

## Understanding the economic cycle

The four key phases of the "economic cycle", help to explain how economic activity shrinks and grows over time.

After a period of economic expansion, where productivity and growth are high, there usually follows a slowdown. The term 'recession' is used when a country's economy records two consecutive quarters of negative GDP growth. Once growth begins to pick up, the market moves into the recovery phase, and then completes the circle with further expansion.

At present, it would be fair to say that the UK economy is in the 'downturn' phase of the cycle, and could be heading towards recession if economic conditions continue to deteriorate.

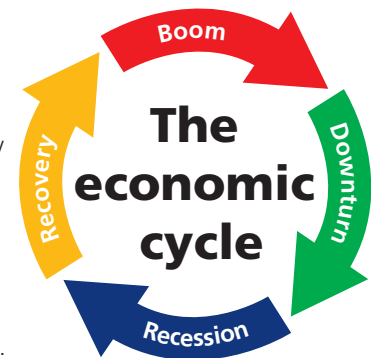


Chart 1



Chart 1 shows that after every major economic crisis of the last three decades, stock markets have recovered and, after a brief period, continued in an upward path. The current environment could be considered as yet another example of the economic cycle reasserting itself.

## If you hold an investment

Given the recent market weakness, you may be worried about your investments and wondering if now would be a good time to sell. The first thing to say is 'don't panic'!

It's often very tempting to sell your investment during a period of volatility, which is why investor selling their assets helps drive markets further down. However, some investors view market weakness as the ideal time to increase their investment.

## If you are thinking of making an investment

Often the best time to invest is when markets are falling, and sentiment is negative. By investing in a fund well positioned to benefit from undervalued companies, you could find yourself with a portfolio of profitable businesses that will do well when the market improves.

Whatever your opinion on today's markets, it is worth taking time to consider your investment objectives, and think about whether your portfolio is on course to meet them.

**“ Most people get interested in stocks when everyone else is. The time to get interested is when no one else is ”** Warren Buffet (CEO, Berkshire Hathaway)

# Ask yourself some important questions:

## 1. What is your investment time horizon?

If you are saving for the long term, you may be better off leaving your investment to ride out the current storm, whereas if you decide to sell because your investment is no longer worth what it was, you may simply be wiping away the possibility of your investment making a recovery.

Sometimes doing nothing can be the wise call. The MSCI World Index as shown in chart 1 demonstrates that investors who hold onto their investment in the difficult years have historically been rewarded for their patience.

### Pound cost averaging in practice

Another point worth mentioning is the benefit of 'Pound Cost Averaging'. Investing regular amounts over a set period of time means your investment will be buying more units when prices are low, which will ultimately be worth more when markets recover. The tables below demonstrate how pound cost averaging can sometimes work to an investor's advantage during both falling and rising markets.

#### Markets are falling...

Month	Regular amount	Share price	Shares bought
1	£100	£5.00	20
2	£100	£4.50	22
3	£100	£4.00	25
4	£100	£3.50	28
5	£100	£3.00	33
6	£100	£2.50	40

Ave share price: £3.75

Ave purchase price (£600/168 shares): £3.57

#### Markets are rising...

Month	Regular amount	Share price	Shares bought
1	£100	£3.50	29
2	£100	£4.00	25
3	£100	£4.50	22
4	£100	£5.00	20
5	£100	£5.50	18
6	£100	£6.00	16

Ave share price: £4.75

Ave purchase price (£600/by 130 shares): £4.62

## 2. Is your portfolio well diversified?

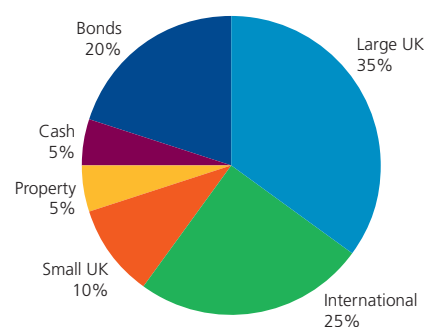
A combination of different asset classes in your portfolio will help to preserve your investment during difficult times. It might be worth thinking about changing the structure of your portfolio in order to help spread the risk and continue to generate returns whatever the climate.

For example, if you have a large portion of equities in your portfolio, you might consider moving some of your investment into the fixed income market, which is better positioned to deliver returns with a lower level of risk than equities. You might also consider moving some of your equity investments into lower risk funds, for example those in the Cautious Managed fund sector.

The pie chart shows a hypothetical investment portfolio for an investor aged 40 with a relaxed attitude towards risk and prepared to invest for a 10-15 year period.

Because of this, the portfolio has a large equity weighting. However there's also a significant allocation to bonds, property and cash. This should provide some degree of protection if equity markets (UK and International) underperform.

A well diversified portfolio should be able to deliver returns in any market conditions.



## 3. Is your portfolio capable of weathering the current storm?

If your portfolio is made up of funds that performed well during the recent market conditions, it may be worth having a fresh look at their performance this year. Sometimes the investment strategies of fund managers are better suited to good market conditions, and chances are some of your big name fund managers have not been faring so well recently.

**Please note:** For help or advice on your investments we recommend that you speak to your Independent Financial Adviser.

“ Look at the market fluctuations as your friend rather than your enemy; profit from folly rather than participate in it ” Warren Buffet (CEO, Berkshire Hathaway)

## Plan of action

Hopefully you will now have a better understanding of recent events, and the impact they could have on your investment in the short term. You should consider the following questions:

1. Is my portfolio well-positioned to weather the current market conditions?
2. Are there any changes I could make to my portfolio to make it less volatile?
3. Am I still on course to meet my investment objectives?

**For help or advice on your investments we recommend that you speak to your Independent Financial Adviser.**

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