New Minerva Report

Forever Blowing Bubbles

The TMT boom that we witnessed at the turn of the millennium was a classic *bubble*, and we are still living with the consequences. Investors always seem to exhibit excesses, although not all of these would be classified as *bubbles* in the true sense of the word. We are currently witnessing two. One is in the process of deflating, and the other is still being expanded. Both have implications, direct or indirect, to markets.

The one that is still growing at the moment is the buy-to-let market. During the past year you can not have picked up a financial newspaper without some mention of this 'safe as houses' route to riches. It all sounds so easy. You borrow money, buy a property, then you let it out. The rent easily covers the cost of borrowing, and the value of your property will rise forever. It doesn't require a brain surgeon to recognise how easily all this will untangle. Firstly, we have the cost of borrowing. Rising property prices, up by 17.9% in a year, are already putting pressure on the Bank of England to raise interest rates. Many lenders have been falling over themselves to lend money to this market. Many have lent 80% or more of the property value. If interest rates rise, the sums start to come under strain. On the other side of the equation the yield on rents has been falling; especially in London, where they are expected to fall to 3%. This has been caused by the over supply of property to rent, caused by the number of properties being bought to let. Additionally, seeing the rises in house prices and the low interest rates, many first time buyers have been trying to jump onto the bottom of the property ladder. Don't think for a moment that just because a respected building society is prepared to lend the money, then it's all OK. Just like the banks, they get roped into the herd mentality.

Finally, how short are people's memories? Doesn't anyone remember the negative equity crisis in the property market at the beginning of the last decade? It won't take very long for the liquidity in this market place to dry up, if investors try to sell their properties. For those of us invested through collective investments, the indirect implications are two fold. Firstly, if the bubble continues to inflate, the Bank of England's hand may be forced, and interest rates will go up. Secondly, when it all comes to a messy end, the banks and building societies most involved, will get hit by bad debts. This will have a knock-on effect across the whole sector. With four banks in the top 10 shares of the FTSE, this will not be good news.

That leads us nicely onto the other bubble that is in the process of deflating. This is the 'Large Cap' bubble. At the end of the last decade, the investment wisdom was that over a long period, no investment manager could consistently beat the index, so it was better to buy the index. Since index trackers, which are run by computers charge less, this was the only way to invest. Here we have the first cause of the 'Large Cap' bubble. The second was how the indices were made up. Most indices nowadays are calculated by weighting the indices by size of company. (Notable exceptions are the Dow Jones index and the FT30 Index) So, the larger the capitalisation of the company, (number of shares in circulation multiplied by the share price), the greater its weight will be. This is why in the TMT bubble, so many new stocks came into the FTSE 100 index. The top five shares in the

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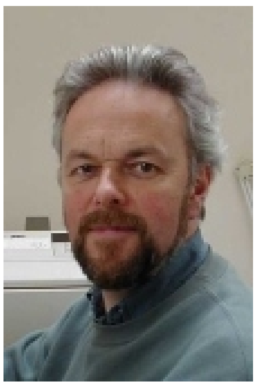

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FTSE 100 Index make up 33.6% of the whole index. The top 10 shares make up 51.4%. If you look at the top five, you will see that all of them got very much bigger by buying, or merging with, other companies: BP with Amoco, GlaxoSmithKline, (as the name suggests also includes Beecham). HSBC has organisations across the globe and includes our Midland Bank. Vodafone represented nearly 15% of the FTSE 100 Index when it took over Mannessman. It now represents 6.1% of the index. Finally, Royal Bank of Scotland includes Nat West. It was the conjunction of index tracker's fund management, and the need to be big for globalisation, that caused the 'Large Cap' bubble. We think that it will take over a decade for this bubble to fully deflate.

We know we have been banging on the drum about index trackers for years. Our April 2000 the front page article 'End of a Trend' tackled the point in depth. We know that at certain stages they will do better than active funds. But over the next decade, as more and more active fund managers start to beat the index, there will be a move away from index trackers, and therefore from the large cap stocks that make up the weights in the index. This will ensure that the FTSE 100 Index will continue to move in a sideways motion. We are not the only people to now think this. In recent weeks we have spoken to two top UK fund managers who agree with us. One said that he believes that the FTSE will not go over 6,000 for the next ten years. That is not quite our thinking. There is a possibility that it could get over 6,000 in that time frame, but it will still come back below it. In other words the index will remain destined to not break and remain above the previous peak, until probably 2012. Many will say that this has not happened in history before. They will cite the mantra of returns from equities over the last century. However, history does give us a very good example of what we are talking about. On 9th February 1966 the Dow Jones Index hit 995.2, just short of the 1000 level. In December 1968 it hit 983.3: April 1971 950.8, August 1972 973.5, January 1973 it broke through the 1000 level and peaked at 1051.7. In September 1976 it hit 1014.8, and in April 1981 1024.0. It was not till December 1982 that the index said farewell to the 1000 level for the last time. Now that may sound really depressing. However, to give you an example of what good fund managers can do. In November 1972, M&G launched an American fund. In sterling terms over the next ten years the fund rose 129% with dividends reinvested. Over the same period the Dow Jones Index was up just 2.1%. The M&G fund was aided by the US Dollar, but even if the M&G data was converted to US Dollars, it was still up 57.8%. So if our predictions are correct, do not despair, we will help you find those fund managers who will produce the returns, and make your money grow.

Enronitis

Just when you thought it was safe to go back in, a new scandal emerges to hit the markets. This time it was Dennis Kozlowski, head of Tyco International, one of the stars in the US bull market, who has been charged with tax evasion on art deals. Although this was a private matter, it was Mr Kozlowski who built up Tyco from a boring engineering firm to one of the world's largest conglomerates. The news that the board had removed him due to the tax probe left Tyco shares down 25% on the day. This just demonstrates the vulnerability of Wall Street to anything that puts a question mark over any of the former Wall Street stars, whether a company or an individual.

Emerging Markets

One of the effects of the questionable accounting policies in American companies has been a change in perceived risks in Emerging Markets. It was always assumed that in Emerging Markets companies had the ability to manipulate their accounts, and do things behind shareholders backs. Now that it has been seen that this was happening at the heart of capitalism in the US, there is a re-assessment taking place.

Shares in Emerging Markets, particularly in the Far East, are cheap compared to the US. Equally, if there is an economic recovery in the US these companies will do well. If there is no real growth in the US, initially they will be hit. However, in the longer run, it is in areas like the Far East, where demographics favour markets. We have seen the beginning of a bull market in this region. After such an initial rally we should expect some set back. This will be a good time to buy.