



## Cheviot Asset Management

As inflationary pressures add a further problem for investors David Miller of Cheviot Asset Management outlines his current views on investment markets.

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This year has seen intense volatility in all asset classes with equities down, government bonds stable and commodities slightly ahead.

Investors have come to recognise the benefits of wealth preservation during periods such as these, particularly after the experience of 2000–2003. However, we face a further challenge this time as inflationary pressures have risen, thus eroding the real value of lower risk investments just when the stability that they offer is at a premium.

In response to this, we have carried out a detailed review of the return characteristics of a wide range of asset classes and made judgements about their likely correlations to each other given current economic and financial market conditions.

Despite concerns about global economic growth, equities remain an important part of any portfolio, with the objective, of at least, maintaining the real value of capital and income. Valuations are attractive and

in the UK, for example, the yield on the equity market is approaching that of gilts, something we last saw in 2003 at the bottom of the bear market. The indices may be down this year but sector rotation has been huge, suggesting that good stock selection will outperform passive strategies. In this era of global trade, the differential performance between geographical regions is less than it was in the past but it is still possible to add value through tactical asset allocation, which is why, we have been adding to US exposure throughout this year.

Bond markets will probably remain schizophrenic with gilts offering poor value, whilst lower quality issues offer the potential of higher returns but also an increasing risk of default, particularly as the economy slows. In the UK, cash returns are attractive but this is not the case in all currencies, particularly the dollar.

With volatility high and likely to remain

so, opportunities in other alternative asset classes have presented themselves. Given our view on equities we have focussed on hedge funds which display a low correlation with equities. This excludes about 80 percent of funds most of which are long/short managers. Hedge fund strategies that are benefiting from current market conditions include those that trade volatility and in particular strategies that in the past have competed with banks in specialist areas such as asset backed lending.

Private equity groups that raised capital last year and do not rely on high levels of leverage are starting to buy assets, including written down loans from the banks at very low prices. Investors in closed ended private equity investment trusts will have noticed that discounts to net asset value are now at extremely attractive levels and careful selection of funds with good portfolios of assets should produce good returns in the medium term.

Whilst doubts remain about inflation and the future course of interest rates, unleveraged real assets like gold and art will continue to attract interest. Apart from buyers of Miami condominiums from distressed developers, many investors are less keen on property than they have been in the past and this is part of the reason why commodities have attracted so much interest in recent months.

A sustained rally in equities probably requires a comprehensive bail out of the US banking system and lower oil prices on a longer term basis. However, less access to credit will slow growth and allow inflation to moderate, leading to lower interest rates and more stable financial markets. Nevertheless, it is still early days and the best way of navigating through these uncertain times is to select a range of different investments which are beneficiaries of the current period of turbulence rather than victims. 