Investing in today's markets

These are undoubtedly challenging times for investors looking to employ capital in today's market. A number of issues ranging from the current political environment and policy initiatives taken by governments and central bankers have a more significant impact on prices of investment assets such as bonds, equities and commodities together with other investment products such as structured products and alternative investment vehicles.

Following the banking crisis of 2008 and 2009, investment professionals such as fund managers and investment consultants are increasingly finding that the models they employed in the past are no longer as effective under the current investment conditions. The main difficulty is that during and subsequent to the crisis governments and central banks took unconventional measures to ring-fence the financial system by injecting it with liquidity. This has resulted in banks delaying the recognition of loses due to solvency problems.

It would be appropriate at this point to distinguish between issues of liquidity and solvency. When an entity has a liquidity problem this is mainly due to the fact that the entity although financially sound finds it hard to finance its daily operations and long term projects because investors are not willing to invest at that particular point in time. Therefore, this problem is only transitory in nature. Solvency issues are of an entirely different nature because they arise from an entity finding it difficult to meet its debt obligations i.e., its capital and interest payments. Under a free market mechanism, where excessive risks are taken by private or government entities, resulting in debt measures being stretched, the imbalances are usually addressed through debt reorganisation or restructuring. Cases include the Asia debt crisis of 1998 and also similar crisis involving Latin American countries.

The actions taken during this crisis were rather different. In fact, we saw multiple initiatives to recapitalize the financial system first in the US with programs such as TARP and measures taken by the Federal Reserve in the form of Quantitative Easing (QE). The latest are initiatives taken by the European Central Bank whereby it is offering banks the possibility to borrow money on a three year basis at an interest rate of circa 1% against collateral deposited. The name for this program is LTRO loans. The efforts made by the authorities did indeed have their desired effect because the financial system is still functioning and the absence of liquidity programs was quite evident when Italy and Spain's borrowing cost ratcheted higher in the latter half of 2011, when countries with similar debt profiles such as the UK and the US were enjoying record low levels of interest rates on their debt.

Notwithstanding all these liquidity injections, the perception towards the market is that unless these programmes are continuous or periodically reinstated the risk that the economies will go back into recession increases. Obviously, this has led to volatility in the markets.

This has created a scenario where investors are finding it increasingly challenging to allocate funds to the financial market on long term basis, be it bonds, equities, and commodities because a change in policy can have disproportionate effect on the performance of investment portfolios. The question that investors are seeking to answer is this: "Without intervention from central bankers and governments will the market be able to sustain current levels or will asset prices deflate?" We believe that the current initiatives are intended to sustain asset prices in order to maintain the wealth effect and compensate for the decline in wealth experienced during the property bubble.

Our understanding is that these initiatives are intended to ignite economic growth which should result in a self-sustained recovery in the economy. This in turn should help to sustain an upward bias in asset prices, thereby facilitating governments and private sector in addressing the debt imbalances. More investment in productive assets should consequently lead to lowering unemployment and a cyclical recovery.

The considerable improvement in economic data in the US, Europe, Asia and emerging markets due to the policy initiatives aforementioned still leave some reservation on our behalf. This emanates from the fact that the economic growth that we had during the first half of this decade and the beginning of the later half was mainly driven by growth in debt and not via income accumulation. This aspect should not be ignored because it is unlikely that consumers are willing to accumulate higher debt.

Investment portfolios should therefore be considered against this backdrop of political environment and added consideration should also be given to other evaluation methods such as technical analysis, behavioural analysis and fundamental analysis. Technical analysis and behavioural analysis involve the study of historical chart patterns to establish the trend of asset prices. These types of analysis involve the study of investors' behaviour because ultimately it is the investor who determines the direction of asset prices through the interaction of supply and demand. Although these are relatively simple tools to use in asset price analysis investors should not underestimate their usefulness in identifying favourable risk/reward scenarios.

A number of other studies relating to credit markets might also be useful. Measures such as the TED spread which is the difference between interbank lending rates and risk free government bonds on a three month basis. This measure demonstrates whether banks, corporations and governments are finding it difficult to finance themselves. A low reading would indicate that credit is flowing freely in the economy and therefore risk of credit events is minimal. A high reading would mean that credit is being restricted in the economy and asset prices could be influenced negatively.

Fundamental analysis is the study of corporate books including profit and loss statements; balance sheets; and cash flows statements. These type of studies do not primarily focus on the quoted stock price of the company but mainly on factors such as: the type of sector; the growth of the company in terms of sales, cost and profits; the return on the capital employed; how the company is being financed (equity versus bonds); its competitive edge; the management performance; the book value; and replacement cost. These values are then compared to the quoted stock price to determine if the company is fairly priced.

A financial professional should be able to guide the investor in making the appraised choices and selecting investment vehicles that match up to one's risk profile. Investing is all in education, preparation and the managing of risks.

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This article featured in Gozo Today newspaper on 31 March 2012