

FUNDAMENTALS

**ROBERT DAVIES**

MOST pundits agree that the UK is in a recession right now, and many say that the economic news is going to get worse before it gets better. Does that mean it is too late to adjust your portfolio? And, if it isn't, what should you do?

Here opinions divide into two opposing camps. One group, the active fund managers, will reason that now is the time to turn defensive and invest in companies that will be least affected by the recession. These will be companies, such as utilities, that offer services we can't live without, along with food retailers and suppliers.

The other camp are passive investors who simply buy tracker funds and ride the ups and downs of the market without trying to second-guess which companies or sectors are poised to do badly, or even perhaps benefit from the events that are about to unfold.

This second course of action might sound perverse. Isn't the stock market all about trying to pick winners and dodge the basket cases? Yes it is, but the game is much harder than it looks, and there are a lot of very smart players in it. Apart from the obvious question of how any individual can choose next year's winners, there are many other factors to consider.

Let's start with valuation.

Companies regarded as being low risk, such as food retailers, are popular now, meaning that their valuations are high.

Tesco is trading on a dividend yield of 3.4% – good, but less than the market yield of 6.3%. Others, like Marks and Spencer, which has fallen from 600p to barely 200p, have yields that might hit 10%.

Won't that have more upside when the recovery comes? Possibly it might. But there is a risk that some companies might not pay all or part of the dividend next year if business conditions deteriorate. So the active manager not only has to choose his stocks, but form a view of whether the downside is already in the share price.

Contrast that with a tracker investor. He doesn't have to worry about choosing stocks because his fund will hold all of them. Whatever happens, he will benefit from the recovery when it comes. While the fund could hold some shares that experience a tough time, the wide diversification of a tracker means that it also holds the shares that do well. That is one reason why there were eight tracker funds in the top quartile of the UK All Companies Sector in October.

The reason for that is that all the tracker funds have large exposures to dollar earners like BP and Shell, and they have gained more from a falling pound than they have suffered from falling oil prices.

What many investors perhaps don't appreciate is that the UK stock market is not a very good proxy for the UK economy. BP and Shell account for about 20% of the dividend income into the UK market, which is why they, and the 23 other global mega-cap companies,

account for nearly half the market value of the UK stock market. Marks and Spencer might figure prominently in investors' perceptions of the UK economy, but in stock market terms it only contributes a third of 1% of the total income, so it hardly counts as a major player.

Investors should stop worrying about the effect of the UK recession on their portfolios and make life easier, and more profitable, for themselves by buying a tracker that gives them good exposure to the global mega-cap stocks listed in the UK.

Robert Davies is founder of Fundamental Tracker Investment Management, based in Glasgow

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