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Stocks to buy for a Christmas rally

Shares usually rise strongly over the festive season, and though 2007 is not tipped to be as profitable as this year, there will still be money to be made, says David Budworth.

The London stock market is on course for its fourth year of double-digit returns, outpacing house prices for the second year in a row and trouncing bonds and cash, despite a setback last week. Britain's best fund managers are now picking the shares they think will carry the rally into 2007.

The strength of shares this year has taken many experts by surprise. Last December, analysts predicted that the FTSE 100 index of leading shares would manage a rise of only 2 per cent, but instead it is up 8.9 per cent this year at 6,122 thanks to strong global growth and rampant takeover activity. Once dividend payments are included, investors have gained a total of 13 per cent.

Traders are hoping that the traditional December "Santa rally" will boost the return from equities even further. Since 1935, the market has risen in December 80 per cent of the time, according to stock-market historian David Schwartz.

After this strong run, some advisers say investors should not expect such a good year in 2007. Anthony Bolton, manager of the Fidelity UK Special Situations fund, gave warning that markets could be due another repeat of May's shake-out, when shares plunged 9 per cent.

Others are more sanguine. Stephen Whittaker, who runs the New Star UK Growth fund, said: "Everyone seems to be worried that America is going into recession, but that won't happen because it looks likely the Federal Reserve will cut interest rates. With rates at 5.25 per cent, it has plenty of room for manoeuvre."

British shares could even become a safe haven as the global economy slows.

HSBC thinks the index could finish next year at 6,640, a respectable 8 per cent gain from Friday's level.

Roger Noddings, chief investment officer, said: "If there is a significant slowdown in economic growth in the US then we would not be surprised to see evidence of a 'flight to quality'. Large UK companies should benefit."

Jagtar Sidhu, 33, an investor from Willenhall in the west Midlands, is happy to stick with his investments in anticipation of a good 2007 after strong returns this year. His fund, Schroder UK Mid 250 fund, has risen 32 per cent over the past 12 months. The IT specialist said: "Growth has been phenomenal, better than I had expected."

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Ed Burke, manager of the Invesco Perpetual UK Growth and UK Aggressive funds, also thinks the outlook is benign. He said: “Valuations remain reasonably attractive so I think we are in for a year of markets gently going up.”

So the consensus is more gains, but probably in single digits. Professionals say it will still be possible to make bigger profits by picking the right shares.

Many of Britain’s best fund managers have made a name for themselves by buying undervalued shares with recovery potential. It’s a simple theory: a stock that is unloved and cheap has the potential to make bigger profits than a fashionable stock where the valuation is already high.

The strategy has become more difficult, with most sectors having had such a good run, but managers say it is still possible to find bargains. Dividends can provide a good indication of value. Royal Bank of Scotland, for example, is yielding 4 per cent compared with 3 per cent for the FTSE 100 index, suggesting it is cheap.

The American fund manager Michael O’Higgins discovered that buying the 10 top-yielding shares in the US Dow Jones index at the start of the year and holding them for 12 months tended to produce better returns than the market as a whole.

O’Higgins’ method has been tested in the UK as well, where it was found that buying the five smallest of the top 10 high yielders produced the best results. On this basis, you would buy financial stocks Alliance & Leicester and Bradford & Bingley, the retailers Kingfisher and DSG International and brewer Scottish & Newcastle.

If you are not happy picking stocks, a fund that pools your money with other investors and is managed by a professional is easier and less risky.

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