WALKERCRIPS STOCKBROKERS

A PERSONAL VIEW FROM PETER BENNETT

2014 STRATEGY - PART II

Readers- perhaps read the last two paragraphs first.

Investment – same old, same old

"As a general rule, when Wall St gets excited it is best to keep a firm grasp on your wallet"; Edward Chancellor, GMO (from FT).

John Hussman recently and very correctly quoted J K Galbraith (A Short History of Financial Euphoria): JKG lamented the "extreme brevity of the financial memory … in consequence financial disaster is quickly forgotten. In further consequence when the same or closely similar circumstances occur again, sometimes in only a few years, they are hailed by always a supremely self-confident generation as a brilliantly innovative discovery in the financial and larger economic world. There can be few fields of human endeavour in which history counts for so little as in the world of finance. Past experience, to the extent that it is part of memory at all, is dismissed as the primitive refuge of those who do not have the right insight to appreciate the incredible wonders of the present". He goes on to suggest that these are 'flight into what must conservatively be described as mass insanity'. Ed – Amen. As readers know, the **first** thing to do when wishing to manage money is to study financial history. Deep and often.

"The incredible wonders of the present"

This is clearly QE^n. (In 1990 infotech – in 1960s computers and electronics; 1920s mass production of consumer goods; early 1900s steel, railways. All bull market tops.)

I show below verbatim what I wrote near the top of the tech / general equity end century bubble. Always such tops feature far too easy money and some new, new thing which will 'change our lives' and 'won't go away'. These phrases are endlessly parroted. Needless to say, from the investment point of view, they are completely irrelevant. Per the quotations below, it was ever thus.

Repeat – investment is like Agatha Christie novels. Different details, same gist each time (in Agatha Christie it's usually the least likely wotdunnit).

OK, QE is not held in such regard as the events described above, but it has assumed a similar quasi-religious mystique, such that perceptions and emotions, engendered by a reckless monetary policy has undoubtedly (yet again) driven values up to distorted levels. In some cases one can probably already use the word 'bubble', e.g. agricultural land in the US, top quality art, Hong Kong and much other real estate, US small cap equities, social media equities. And unlike the other historical examples of new, new things – QE actually 'produces' absolutely nothing of any value. Rather, it merely robs one part of society on behalf of another with no 'by your leave' from the former.

6th March 2001

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PSYCHOLOGY

TRICK QUESTIONS

Near the top of which US stockmarket peaks were the following observations made? 1900/01; 1929; Late 1950s-mid 1960s; late 1990s?

To avoid giving the game away I have, in a handful of cases, changed the precise wording – to take out the give-away of old style expression.

The huge wave of mergers and acquisitions will remove excess capacity

Increase in consumer credit . . . increased prosperity

The ownership of stocks has changed hands . . . public speculators do not now own them.

There is huge technological progress to come

Talk rife about expansion and a prosperous hi-tech future

A time of massive technological progress . . . unusually apparent to even the casual observer…

. . . nothing to prevent the US from enjoying an era of growth unparalleled in history…

new world of finance…new era of global business…outlook for rapidly increasing earnings.

Research and invention proceeding at a faster pace than ever before…gradually to be applied…further earnings increases can be anticipated from them

War is a receding threat . . . jobs are . . . plentiful . . . promises. . . that taxes will be cut . . . a depression scare has come and gone without amounting to much . . .

Within a few short years, Americans are regularly spending hours watching an electronic screen.

Inflation is public enemy number one. We have either eased or restricted credit when necessary.

Capitalism has broadened out . . . thousands of workers have become owners of the firms they work for via employee stock purchase plans.

The baby boom will make this new era different from . . .

Businesses can enjoy reasonably continuous growth indefinitely … better control of monetary policy than ever before.

ANSWER

Most of you will probably feel that you have been reading excerpts from recent newspapers or brokers' circulars.

Whether you have guessed right or not NONE of these observations that I have lifted were made re the late 1990s' bubble. ALL could just as well apply.

Yet again, finance is like an Agatha Christie novel. The names change; the plot is more or less the same. Goodness me, so much of this game is bog standard. Dead simple; endlessly repetitive. And so few realize this.

I am indebted to Robert Shiller *"Irrational Exuberance"* – for all of the above.

In the words of Hugh Hendry, in today's (9 December) FT: "in the wacky world created by such monetary fidgeting there is one reason for being long markets (Ed: being invested) and one alone: sovereign nations are printing money and prices are trending. That is it. This is pretty much in line with the theme of strings of these Bulletins, though looking backwards it was indeed possible with confidence to identify many areas of extremely good value (not US equities) at the turn of 2008/9. Very few now.

1930s revisited?

In the 1930s a bad situation was made worse by tariff barriers and other trade restrictions. Under a different name we have the same nowadays. It's called ‘QE^n’. Instead of dealing more summarily with the underlying problems of excess credit and debt heaps, governments are in effect indulging in a competitive money print. The result being to export the slowness of economic recovery, resultant from debt heaps, to other nations, who respond in kind. Under this scenario, it goes like this: the worse the economic situation that a nation finds itself in, the more it ‘prints’ and so the more you should invest in its shares! The lunatics run the asylum. Truly.

Europe

Mr Hendry cites the dire, probably insolvent (Ed: and per these bulletins), state of much of the European banking system as, in this context, this is a bullish reason for buying shares! Under the argument, also per these bulletins, that investors don't worry about the same thing forever and with the immediate crisis under control in Europe, investors have glossed over the fact that the near insoluble economic problems have not been addressed. Thus the attraction of low European equity valuations comes to the fore. To be more precise, the Shiller PER on European stock markets at 12½, is almost exactly half the valuation level of the US stock market. Mr Hendry concludes “it will all end badly; … but in the meantime stock markets look to us much as they did in the 1928 or 1998.” I can't argue. A melt up is quite possible as crowd insanity and career terror amongst professionals, notably in the over-valued US, intensifies. Recently a superbly arch comment came from the boss of Leuthold – a US investment firm – to the effect that private investors had not yet at the beginning of the year (2013) stopped selling and started piling into the market because shares had not yet become expensive enough. With even worse value evident, hey, it's time to party! They're piling in now.

Graphical illustration of the effect of QE is shown in the self-explanatory chart from RMG Wealth Management shown below:

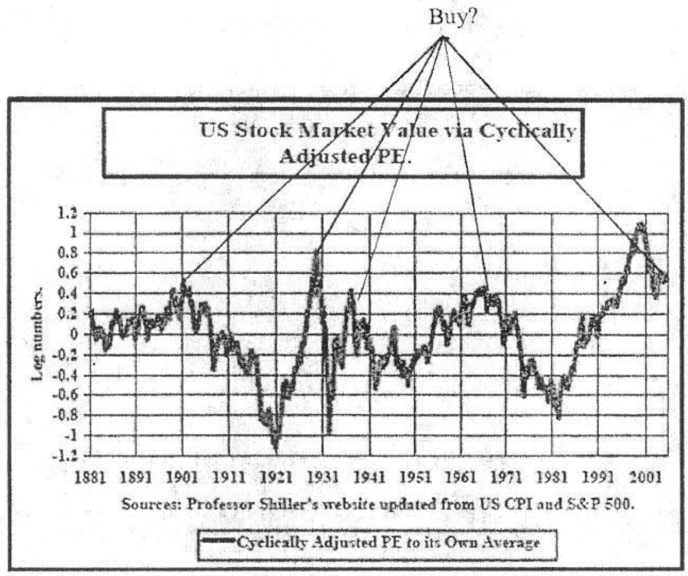
The market lifts when QE lifts.

The Fed is beginning microscopically to taper its purchases of government and mortgage bonds. This has been running at a combined total of over $80 bn a month. And so the addict doesn't suffer withdrawal symptoms, some sort of forward guidance on Fed interest rates is a key part of policy. Whilst this has been taken as good news for stock market bulls *pro tem* common sense suggests that the future is always so uncertain that one cannot make promises in this sort of matter and hope that intelligent people are going to take you seriously. In sum, investment is currently dominated by Fed witchdoctory, as opposed to choice, based on long-term value. ‘Guidance’ is merely a comfort blanket. For those souls who need to be comforted. (Ed: if you’re “comfortable in” this game, you’re probably wrong. The ideal is to be the investment outcast at the 19th hole.)

I copy from a turn of the century bulletin to illustrate current probability for longer-term returns from Wall St equities. They were valued fairly similarly to now.

Graphs 3 & 4

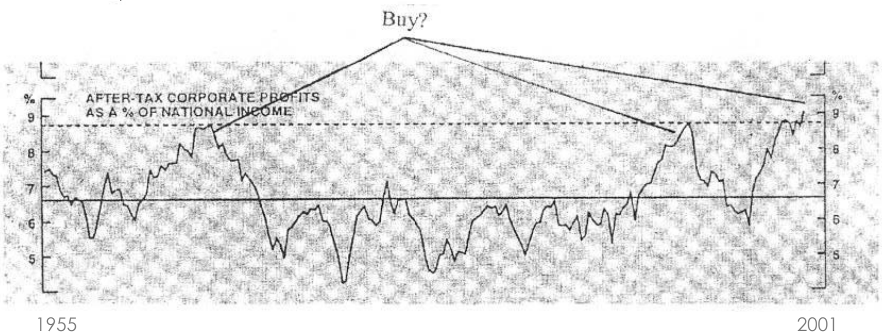
The graph below again shows, *inter alia*, a Graham and Dodd valuation of Wall Street



← here now

Courtesy Smithers & Co.

And this shows profits to GDP



← here now

Courtesy Bank Credit Analyst

Plus ça change.

Currently, per ‘Q’, Shiller, Price to Revenues, and incidentally, current yield, Wall St is likely 70 % + over-valued from an investment perspective. Gamblers can do what they like.
(Sources: Smithers & Co, Hussman, GMO, and similar)

Gold ($1259)

In my last piece I suggested there was no reason currently to be in gold (down 40 % ±). Gold **shares** may be different. Buying after a 65 % decline, despite a grim immediate fundamental prognosis, is usually a good policy provided underlying value is there. This is illustrated by the following quote from a bulletin I wrote on 12 October 2007 as the various crashes got underway, including US housing. The relevant piece is about US homebuilders where I did indeed buy a tracker (and sometime later UK housebuilders) – needless to say, sold too soon! I have recently bought a small starter position in a gold shares tracker, where risk appropriate.

"Studies suggest that if you buy into a lasting asset class after a fall of over 60%, you can normally expect to make a very decent profit over two to three years.

I show below the US homebuilders Index. Down 67%.

Based on what is happening in the real estate market, there is not an iota of a reason to suggest buying. Which, of course, is a major reason why the shares are so low. "

At the top of the tech bubble value stocks were not polite conversation. I invited 'Fund Manager', who wrote a weekly piece in the Investors Chronicle, to lunch. He had told readers that the pension trustees whose funds he looked after only wanted to hear about tech. Value was, well, a five letter word (Bank is 'four' nowadays, justifiably though). He, a decent chap, was of course aware of reality, but I refer yet again to 'career risk – the performance killer. **Must** join the lemmings. UK value shares had already had a two to three year bear market and 'value' was screaming at you, despite the incipient bear market. So I stuck a list of value shares - wildly unpopular – into this bulletin near the top of the tech bubble. (I am, incidentally, not nowadays authorized to refer to individual stocks under 'modern' rules). Exact quotation below:

RETROSPECTIVE

Unprecedentedly for these bulletins (bar Christmas "for fun") I sent out a list of shares about a year ago for strategic investors. Dixons should not have in fact been on the list. I made a miscalculation regarding its PER and immediately wrote a note of apology. However I include it in the summary. I put the list out as the "probability" involved verged on one of those occasional lifetime opportunities. The FTSE since then is near 8% lower. (NASDAQ down 60%!)

Results

	Then (p)	Now (p)	% change
Dixons (electrical goods retail)	294	243½	- 17.2
Rexam (packaging)	213	280	+ 31.5
Scottish & Newcastle (beer brewing)	437	538	+ 23.1
Glynwed (industrial/utility pipes, catering equpt.)	223	242	+ 8.5
Norwich Union (life insurance)	430	478 (equivalent)	+ 11.2
Laporte (specialty chemicals)	495	691	+ 39.8
Jarvis Hotels (3/4 star UK Hotels)	100	107	+ 7.0
Powell Duffryn (UK ports, engineering)	342	650	+ 90.1
T I Group (specialist engineering)	310	356 (minimum)	+ 14.8
Alvis (light armoured fighting vehicles)	90	116	+ 28.9
Beazer (UK house-building)	117	213½	+ 82.5
Pilkington (glass)	74	119	+ 60.8
Thames Water (water)	708	1215	+ 71.6
Wolseley (builders' supplies)	337	453	+ 34.4
Diageo (spirits, Guinness, US food)	471	720	+ 52.9
		Average	**+ 38.3**

"Value" as a theme has (correctly) had a huge rise this last year or so. There is still some value left. However the 80% shot is gone and I shall not refer to the list again. Also, incidentally, very high income was achieved.

Re the growth section one tiny company spoiled the rest:

	Then (p)	Now (p)	% change
Landround (promotions)	290	326 ½	+ 12.6
Accident Care (car accident care)	107	32 ½	- 67.6
Johnson Matthey (specialty chemicals, catalysts, precious metals refining)	737	1119	+ 51.8
		Average	**- 1.1**

Half the value list were taken over within a few years.

I cannot help but refer again to the grotesque idiocy of the investment fraternity end-20th Century (think tulips, South Sea Bubble). All the facts shown below were available to anyone who got off their backside and did some homework. Not one iota of genius, big brain, required. Finance 101 stuff.

> "Reverting to Johnathan Davis' article; he refers to recent work by the advisory firm, Stern Stewart, which indicates what operating profits growth will be needed for the shares in Microsoft, Cisco, AOL and Yahoo!, so as to make their shares fair value (not defined - but I presume relative to bonds).

Over 10 years Cisco must compound at 45% per annum. AOL (pre-merger), at 67%, Yahoo! at 95%. No figure given for Microsoft.

Over 20 years the four have to average over 30% per annum. Note: these are top quality companies, not the rubbish,

Latest Operating Profits	Cisco	Yahoo!	AOL	Microsoft
Profits ($M)	2096	61(est)	726	7785

Total: Approx. $11bn

If one compounds this figure at 30% for 20 years and takes, say, a 15 or 30 multiple of operating profits after 35% tax (for ease of calculation I do not make an attempt at pre-tax figures), the resultant value would represent about half or, alternatively, the total value of then GDP – assuming that GDP grows at 5% p.a. ...

... STRATEGICALLY, A CLASSIC AVOID

The hi-tech counter argument: people tell me that in a year or two we will be able, by voice, to switch on our cooker at home as we sit on the homeward bound train – and watch on – retina – projected three dimensional sporting events, films, etc. Marvellous, but so what? The food will be 'real' (I hope); it will have been stored and transported; the saucepans will have been made; the cooker built; likewise the house and the gas/electricity generated and I will need my (manufactured) glasses to see what's going on. If anyone can think that 70% of the 'value' (high tech currently valued at 70% of US GDP) should be placed on the virtuallity and 30% on the reality, I am afraid you have lost me. As a punt I would go for a 10-20 / 80-90 split. Crudely, I therefore suspect that US tech is 60-80% overpriced; rather worse than the "correction!" in the AOL share price. ...

... TRADING THE NASDAQ BUBBLE

The NASDAQ INDEX, as I finish writing (11/2/00), still moves ahead. However, breadth has been deteriorating in this market (too) for some time. Re "net" stocks, half last year's IPOs now stand below issue price and the "supply" of such stocks is exploding. The US net bubble is probably already ending. FAR MORE IMPORTANTLY OVERALL US MARKET LIQUIDITY IS BEING SQUEEZED. THIS IS A TOP RATE TIMING INDICATOR (UNLIKE ADVANCE/DECLINE)....

... The Fed is well behind the curve and the squeeze can only tighten. Indeed it verges on the axiomatic that so high is confidence and domestic demand and so rampant credit growth, that it is hard to see the necessary slow-down occurring without cracking stock market investor/borrower confidence. Effectively a lose/lose situation. Be very careful indeed. ... "

Even on timing the Fed was as good as marking our card. They might as well have said 'sell'. (Clients and I were very lucky at that time. More than ever in my investment management history. I'll likely never do a repeat. But that's another story.)

Ed: NASDAQ fell 80%.

Again and/or value (and lack of it) spoke.

I end by suggesting, once again, that those who take their money seriously and want to learn more about investment should start with economic and financial history, before going on to the technicalities. One thing which will by now have struck you is that this is a subject substantially about human emotion and behaviour. Endless hours, weeks, years, you name it, have been spent trying to quantify and pin everything down and come up with neat economic and investment theories. This reflects the human wish for certainty, knowing what the future will bring. Measurably, this just does not work in any practical sense. Indeed, the attempted quantification, using even the most powerful of computing techniques, which was pursued by the PhDs and economic Nobel Laureates in the run-up to the crash achieved nothing. Except to compound the effects of the that crash.

Talk and theory are indeed cheap. Those managing their own or other people's money need primarily to get a result. This is a practical and behavioural matter, rather than a theoretical box-ticking one.

Hedge Funds

I have been negative about them for some time and I have just read in the FT that 2013 was the fifth year in a row that they under-performed the S&P Index. It was not ever thus. I enclose the exact text from a bulletin that I wrote around the turn of the century, when I began to become negative on hedge funds. The point to take away is that, as nearly always in investment, once you follow the herd, what the great and good advisors say, it's too late. The very early hedge funds actually did quite well. There were a very few highly talented individuals who could perform what is a much harder task than running conventional long-only investment portfolios. Every two-bit manager who thought he'd like to line his pockets, on the back of the previous record of successful hedge funds, makes the whole affair become what it is today. Also 1980-2000 enjoyed an unparalleled market 'trend'. Genius is being at your desk in a bull market. With borrowed money. The last five years have been far trickier. Skill has been needed.

AN ALTERNATIVE: HEDGE-FUNDS

Be a bit careful here. I have been in favour of hedge fund investment for some time. I suspect that a lot of the very few really talented investment managers have become fed-up with the recent way institutional investment management life has developed (no way could I myself work in the typical integrated house) and have either gone conventionally independent or set up hedge funds. The latter have, on average, been extremely successful in recent years. Indeed for a while I held some shares for a client in an investment trust that invested in a spread of such funds. From a large "discount" to asset value the shares ultimately went to a scarcity "premium", by which time I had sold. Investment trusts that go to premia (pound notes for, say, 110p!) are warning signals of temporary scarcity (good) which will, however, soon become excess supply (bad) – the way capitalism works, as I pointed out in late 1999 and onwards re telecoms, dot.coms etc.

It is clear that a cascade of hedge funds is going to hit us. Before investors rush into any new funds consider:

1 Arguably many of the most talented managers have already gone down that route. The supply of such people is very limited, but the supply of second rate managers marketing themselves under the increasingly popular label "hedge-fund" is limitless. The discovery of the success of hedge funds is a marketing department's dream; a

punter's ultimate nightmare. It's probably exciting and remunerative (while it lasts) for the fund manager concerned. But that's not the point.

2 Quality can only deteriorate henceforward. Above all, if a manager can't run an ordinary fund well, his/her chances of running a hedge-fund (more demanding) decently are minimal

The nearest I myself get to all this is that in recent years I have run low/medium risk portfolios on a "ratchet" basis. This is semi-hedge fund. When I just started in the business I tried running both "long" and "short." It didn't work well – though I did not pursue the idea for long (for obvious reasons!). I find "long to cash/equivalent" as opposed to "long and short" is readily manageable. As I pointed out in a similar investment philosophical piece in December 1996, first of all you have to find out how you relate to markets – what you're good at and what you're not – and drop the latter.

As a last thought, I again emphasise the overwhelming importance of behavioural influences. Beauty or ugliness is totally in the eye of the beholder. The vast portion of all the big moves in stock markets, secular bull or secular bear, are not due to the underlying changes of fortunes of the companies comprising the market. They are due to the perception of the companies as generated by the feelings, usually highly emotional, of the investment fraternity.

Per Andrew Lapthorne (in the FT) nearly all the rise in Wall Street equities these last two years is due to perception (multiple expansion in broker babble). Historically multiples have fluctuated between about 5 and 40 times earnings. And no the long-term fortunes of companies in aggregate do not change by a factor of 8!

Incidentally, overseas investors, with the generally let-it-all-hang-out attitude by the US authorities to the dollar, on average lose over 40% of gain from 1985; over 20%, during the last decade or so. But if 'ease and print' is the policy answer to every problem, your currency is likely to turn out as pretty much rubbish. Indeed, since the Fed was invented a century ago, the dollar has lost 96% of its purchasing power. Mostly since Nixon cut the last tiny link with gold in 1971.

It is called the safe haven currency.

Note

Some or all of this note is didactic / historical. Didactic to help those who would learn to manage their own portfolios (and thus not need me); historical as a tiny bow to those who have suggested I write a book linking the bulletins to financial history. History as so often a testament to human frailty.

I doubt I will write a book. It's all old hat. And who has heard of the undersigned? My various invitations by the media (TV/papers) were forbidden by my firm. Incidentally, I knew of someone who was man-handled out of the studios of a US news channel when it was discovered he was going to make similar utterances to the undersigned – at the time leading up to the credit crash. Such are the charms of vested interest. As they say, "stuff happens, we must get used to it.".

Good luck.

Peter Bennett, BA Cantab, MBA Wharton
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