►On Target

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The Tribe with Winning Characteristics

Jews are outperformers in many realms of human endeavour. For example, they won 22 per cent of all the Nobel Prizes in the last century, and their hit rate moved up to 32 per cent in the early years of this century, although they constitute no more than 0.2 per cent of the world's population.

Why are Jews so successful?

This is a subject most of them prefer to avoid because it draws attention to something that has stoked hostility to them over the centuries – so many of them seem to be generally superior to most of the rest of us in making money, running businesses or professional practices, achieving intellectual breakthroughs, delivering outstanding achievements in the arts and sciences, and in many other ways.

How come?

Although not all Jews practise their ancient religion, or even any religion, they all stem from an ancient tribe whose members were dispersed from Palestine more than a thousand years ago and established communities elsewhere. The most prominent of these were to be the Ashkenazim, who settled in Europe.

Jews constitute several closely-related, identifiable, ethnic groups.

Nicholas Wade, an eminent science journalist, says in his explosive new book *A Troublesome Inheritance*:* "DNA analysis shows that Jews are a definable set of populations." Researchers into genetics at Stanford University in the US have been able "to distinguish with complete accuracy between Ashkenazim and non-Jewish Europeans."

Jews, at least until very modern times, maintained a high degree of ethnic integrity, not only because of their own religious prohibition on marrying outside the faith, but also because they developed specific characteristics that set them apart… characteristics that tended to make them wealthier and more successful.

Wade suggests those were rooted in cultural factors that became embedded in the genes through a process of natural selection.

It began with the emergence 2,000 years ago of a form of Judaism that insisted on universal male literacy so that everyone could understand and obey the religious laws. Then, and for a long time, that was unique approach to cultivating the intellect.

"In a world where most people were illiterate, the literacy of almost all Jews gave them a decided advantage in any occupation that required reading contracts or keeping accounts," Wade writes.

In Europe, in particular, Jews became heavily engaged in financial business such a moneylending, cash transfer, and eventually tax farming. Recent historical research suggests that this was not, as commonly supposed, because Jews were forced into moneylending by exclusion from other ways of earning a living, "but rather chose it because it was so profitable."

They enjoyed high standards of living, which enabled Jews "to secure a considerable degree of reproductive success." Because they could afford better nutrition and warmer houses, they had more surviving children. The Ashkenazi population grew from almost nothing in 900 AD to about half-a-million by 1500 AD, and reached more than 14 million by 1939.

More importantly, this relative success promoted the wealth-promoting characteristics of Jews as a whole.

Among all humans, there are characteristics that favour material success, such as higher intelligence, verbal and mathematical skills, propensities to save and work hard, interpersonal skills.

If those fundamentals are allowed to blossom in a favourable cultural environment, they produce material success. For most of human history, until recent times, that has meant the richer the parents, the greater the number of surviving children.

The spread of greater numbers of descendants with high levels of positive characteristics has tended to raise over time average levels in the community. There's an upgrading of genetic "quality" derived from environmental factors!

Because of the established strong heritability of intelligence (proved by studies of twins), and because of historical evidence linking abundance of surviving children to family wealth, researchers at the Utah University have calculated, Wade reports, "that 20 generations, a mere 500 years, would be sufficient for Ashkenazim to have developed an extra 16 points of IQ above that of Europeans."

This explains why Ashkenazi Jews have an IQ "generally measured at between 110 and 115, which is the highest average of any ethnic group."

Designed for life in cities

Interestingly, Ashkenazim generally do particularly well in the verbal and mathematical components of IQ tests, but score lower than average on visuospatial questions.

"This suggests that some special force has been at work shaping the nature of Ashkenazi intelligence, as if the population were being adapted not to hunting, which requires excellent visuospatial skills, but to more urban occupations served by the ability to manipulate words and numerals."

Why is it that the two other groups of Jews, the Sephardim and Orientals, don't have high IQs like the Ashkenazim? (Both have intelligence ratings comparable to non-Jewish Europeans and "are not over-represented in cognitively-demanding occupations").

Wade suggests that historically they were never able to enjoy wealth-promoting, intelligence-enhancing occupations such as moneylending because they largely lived in Muslim regions whose rulers confined them to unpopular occupations such as tanning or butchery.

In conclusion, two interesting points…

► Research has shown that Ashkenazi Jews have had a genetic admixture with Europeans of only 5 to 8 per cent since about 900 AD. For cultural reasons, they largely maintained their ethnic identity.

► With an average Northern European IQ of 100, it can be expected that only four people per thousand would be expected to have IQs above 140. But among Ashkenazim, the Utah researchers calculated, if their average IQ is taken as 110, then 23 out of every thousand should exceed 140. Roughly six times as many!

Wade says: "This helps explain why the Jewish population, despite its small size, has produced so many Nobel Prize winners and others of intellectual distinction."

* *A Troublesome Inheritance: Genes, Race and Human History, by Nicholas Wade, pub. by Penguin Press.*

Gold: an Encouraging New Report

Gold is "near the end of its long consolidation period" after successfully testing its $1,250-1,270 support zone several times, and could rebound from current price levels ($1,317 an ounce at time of writing) to around $1,500 within the next 12 months, suggests the specialist consultancy Incrementum -- before accelerating eventually up to $2,300.

Commercial hedgers have sharply reduced their short positions. "This means that the largest, best-funded and best-informed traders have positioned themselves for higher gold prices," Incrementum's Ronald-Peter Stoeferle and Mark Valek say in their new version of *In Gold We Trust*, widely considered one of the best annual studies of the yellow metal.

The bullish picture of positioning for gold is underscored by the "extreme positioning" of producers in silver, the sister-metal.

"The current structure of the futures markets is a recipe for a pronounced rally."

Favourable fundamentals include:

► The continuing migration of demand for gold from the West to the East, with the growing importance of Asia's burgeoning middle class for the yellow metal widely under-estimated. "Assuming that incomes in China and India will continue to rise, gold will inevitably be one of the beneficiaries of this 'love trade.'"

► There has been a significant decline in speculative activity in recent months. Yet the fact that most one-time bulls now seem to have thrown in the towel suggests gold is now a contrarian investment [with all the positive implications for those who pursue contrarian strategies].

► Gold mining shares have recently experienced a revival. Mining companies have made numerous positive changes, including resetting their priorities, with profitability, capital spending discipline and shareholder value replacing maximization of production. Relative to the metal, the shares are the cheapest they've been since 2000, and now exhibit "a highly asymmetric risk-reward profile."

Sell-side analysts are collectively issuing downgrades of earnings estimates – but "this classical herd behaviour is often a reliable buy signal… Historically, the point in time when pessimism was at its peak often provided reliable entry signals."

My friend and respected analyst David Fuller, a more conservative gold bull, comments: "The gold price looks as if it has bottomed." But he doesn't expect it to do more than "continue to range sideways to somewhat higher over the next few years." If so, that makes gold a useful hedge against disaster.

However, three warning notes…

► Stoeferle can be accused of being too prone to optimism. He was clearly premature a year ago in suggesting gold would reach $1,480 within 12 months. It never got anywhere near that.

► The current correction in gold, with prices down 36 per cent from their peak, is still below the average for the six previous price declines of 43 per cent. So the yellow metal could still fall much further without signalling an end to its long-term bull market.

► My own opinion is that the charts suggest it would be wise for investors to remain cautious. There is still the possibility, perhaps one in four, of another (final?) plunge in the price towards $1,000. Fortunately there is a much higher probability that gold has indeed established a new bottom -- but the charts don't yet signal that a strong rise is imminent.

The Current Outlook for Shares

Few of the indicators support the idea that stock-markets are in a bubble.

In the US individual investors have 65 per cent of their portfolios in equities. Although that's way above their exposure in the early 1980s of 45 per cent, it's still well below the last period of extreme sentiment in the late 1990s, when exposure topped 75 per cent.

Moves in sentiment also don't suggest a bubble – Bank of America Merrill Lynch says its clients have been net sellers of equities over the past few months.

Bullish strategists reckon the US market still has a lot of upside, especially as there is no sign that the small investors and speculators are piling in, which typically happens at a major top.

One pessimist about the immediate outlook is David Bianco of Deutsche Bank, who argues that we're probably in for a summer shock as his preferred measure of stock-market emotions – price-to-earnings divided by the VIX ratio – "has never been higher and is in extreme mania phase."

The well-known commentator Mark Hulbert points out that corporate profits fell sharply in the first quarter to below 9 per cent of GDP, the lowest level in nearly four years.

David Fuller has been predicting that this will be a "somewhat choppy year for Wall Street," with downside risk "limited to sharp reactions for overextended/overvalued sectors and shares."

Tom Stevenson, investment director at Fidelity Worldwide Investment, argues that investors “are pushing markets to new highs in the face of worrying evidence that all is not well.

“Nowhere is this more evident than in Europe,” where stock-markets have doubled since 2009 “in the face of more-or-less non-existent economic growth, dangerously low inflation, still-high unemployment, an uncompetitive currency and sliding corporate earnings expectations.”

Since the beginning of this year “expectations for earnings growth, the ultimate determinant of share prices, have pretty much halved.”

Nevertheless, “Europe’s belated arrival at the easy-money party that the US, Japan and Britain have been enjoying for many years now… will undoubtedly be good for risky assets such as shares in the short term.”

Markets “can detach themselves from fundamentals for extended periods before they collapse under their own weight” and, as Lord Keynes observed, “can stay irrational longer than you can remain solvent.”

For the moment, this seem to be a time “to go with the flow.”

Investing for the Long-Term

Both the US and Europe face “persistent economic stagnation,” warns investment strategist Russell Taylor in *Money Management*.

“Wages are depressed, interest rates are negative and are likely to remain so for the foreseeable future, government debt is incredibly high and in Europe persistently rising, while companies prefer to hoard cash rather than invest.

“None of this is good for corporate earnings, the basic of stock-market health.”

Both the US and UK governments believe that the key to economic health is buoyant stock-markets and rising health prices to make consumers feel rich and maintain or increase their spending, underpinning demand.

But while quantitative easing “pushes up asset prices, helps people buy houses they cannot afford and enables the banks to recapitalize themselves, it does nothing to address the key issues of economic failure, such as loss of productive efficiency, international competitiveness, adequate schooling, or competent government administration.”

Taylor argues: “Advances in technology have upset the economic balance of the world as we had got to know it.

“Outsourcing of manufacturing first destroyed much of the blue-collar work of the Atlantic world, and now looks to do the same to white-collar administrative and managerial jobs.”

Information technology made possible international supply chains whose efficiencies have already destroyed many industries, while by making readily available knowledge that was almost “secret” in the past, it is now destroying most established economic patterns.

Nevertheless, equity investment remains the only long-term solution for savers in a world of low but persistent inflation. But where…?

Taylor’s recommendations for the next decade or two are: “Eschew all financial stocks, be very careful of telecommunications, stay with basic materials and infrastructure, and identify those manages who can reconcile the need for healthcare and opportunity in technology with the rapidly-developing nature of both disciplines.”

The Great Tax Shambles

This excellent report about the UK tax system by my friend Robin Mitchinson was originally published in his blog whydonttheylistentous. He does not live in the UK, but on the Isle of Man, a British tax haven.

The tax regime in the UK is a complete dog’s breakfast. It lacks logic, order and consistency, but with 11,520 pages it is the longest tax code in the world. It is highly desirable but equally unlikely that any Chancellor [finance minister] will ever have the courage to cut it down to size.

Of much greater importance than the sheer complexity of the code is that the general tax regime, regardless which party controls the government, is a huge economic handicap.

It imposes burdens on business that reduce competitiveness.

It creates parasites whose sole function is to find loopholes; they contribute nothing to the economy.

Most importantly, it heavily discriminates against the very people who are capable of making the greatest economic contribution – the ambitious, the aspirational, the upwardly-mobile. In short, Mondeo Man [roughly the British equivalent of Reagan Democrat in the US].

The entire system requires not so much reform as revolution.

Let’s get started with the permanently unpopular council [city] tax.

There are at least two major defects.

The first is that values are not based on reality. They are those laid down in 1991.

The second is that it is regressive -- one of the criticisms of the older rating system that was abolished by the disastrous poll tax. Because it is assessed on property value and not on ability to pay, its impact falls most heavily on those least able to afford it.

One answer would be a hypothecated tax whereby the money need for local services is recovered through an income tax precept collected by HMRC [Britain’s IRS] and transferred to the local authority. For years the so-called public-sector financial experts have said [that would be] ‘unworkable’, despite the fact that it works perfectly well in some other countries. People then would be able to see exactly the cost of local authority services.

The business rate [local tax] needs reform at the same time. This is a major handicap for small businesses in particular, with the rate often exceeding the rent.

Next, income tax.

The top rate is 45 per cent, right? Wrong. For those family people earning between £50,000 and £120,000 the rate can be closer to 60 per cent when the progressive withdrawal of child benefit is added to the equation. Add in National Insurance and the top rate now exceeds 70per cent for a family with four children.

Labour's proposed 50 per cent top rate is purely class-warfare; it will raise almost no revenue. Someone should explain the Laffer Curve to Ed [Opposition leader Ed Miliband].

There are now 5.3 million higher-rate income-tax payers, up from around 2 million.

National Insurance is a scam. It was introduced to pay for pensions and other welfare benefits. For years. Like the Road Fund, it has been systematically plundered by Chancellors [finance ministers] who use it as yet another stealth-tax.

Then there is inheritance tax, a deeply unjust levy.

It does not hit the seriously wealthy. They can easily hold their assets in trusts, offshore companies, and other 'tax efficient vehicles'. Once again the primary victims are 'people of the middling sort' whose principal wealth is their house, an easy catch for the tax-man. And this is tax on tax, because the assets have been accumulated out of taxed income.

Capital gains tax raises only 1 per cent of total revenues, but it is quite a handy tax-dodge if revenue can be converted into capital.

VAT is an absurdity, and it was no more than poetic justice that [finance minister George] Osborne was seriously embarrassed by the Pasty-tax Fiasco. A chocolate-covered ginger-bread man is loaded with 20 per cent VAT. If only his eyes are chocolate, he is VAT-free. It really is that barmy.

The serious issue is that the tax-base is very narrow, with rafts of exemptions. Broadening the base might allow for the total abolition of corporation tax.

Stamp duty [on property transfers] is an anachronism. It was introduced in 1694. It is a fetter on land transactions, and high time it was pensioned-off.

But it will all be a case of plus ça change.

The Isle of Man has zero corporation tax, no inheritance tax, a top rate income tax of 20 per cent, 3 per cent GDP growth even in these straitened times, about 2.5 per cent unemployment.

I'm all right, Jack!

Why Lower Equity Returns Look Likely

Optimistic arguments about longer-term profits to be made in US shares are "deeply flawed" as they're based on double-counting and circular reasoning, Brett Arends argues on *Marketwatch*.

Future returns are extrapolated from past returns. But a dramatic upward re-rating of stocks was experienced in the past. It's unlikely that can be repeated.

Back in the 1920s, investors typically paid about $13 for a basket of shares generating a dollar a year in net earnings. Today it would cost you twice as much to buy the same amount of earnings.

“Maybe shares really were undervalued before,” Arends says. “Maybe investors will always pay $26 or more in the future for each dollar of earnings. But to count such past gains in your future expectations is to engage in circular reasoning – or a wild set of assumptions. To get the same one-off gain in the future, stocks will have to go all the way up towards 50 times cyclical earnings.”

The second mistake is to ignore what’s happened to dividends, which in the past accounted for a big proportion of the total returns from shares. Until the early 1980s, the stock-market typically boasted a yield above 5 per cent. Today it’s less than half that. Every year your dividends are contributing much less to potential returns.

Investors may expect to get a little more back in the form of equity repurchases. “But they shouldn’t count on it,” Arends says. “Companies have a terrible record of buying back stocks at the wrong time.

“More importantly, while they buy back stock with one hand, they issue lots more to the [chief operating officer] and other favoured insiders with the other. The net effect is that overall share counts go down a lot less than you expect – and… may actually go up.”

What comes out of the wash? Predictable future average annual returns “drop about three percentage points.” Investors today “shouldn’t be expecting real returns of 6 per cent or 8 per cent, as they have seen at times in the past, but much more modest real returns of around 3 per cent.”

And that’s ignoring the most bearish spectre for stocks – that valuations could undergo “reversion to the mean” and fall back to what they were in the past, savaging capital values.

Parking Lots for Superyachts

It seems clear that the world’s largest group of wealthy people now live in Asia, no longer in North America.

The total wealth of high net worth individuals in Asia – defined as those with investable assets of $1 million or more – is projected to grow from $12 trillion in 2012 to nearly $16 trillion next year, according to a study by Royal Bank of Canada and Capgemini.

One consequence is that Singapore will overtake Switzerland as the wealth capital of the world within a decade, experts suggest.

Chinese investors have become the biggest foreign buyers of apartments in New York, London and Sydney.

The Economist Intelligence Unit says Asia will soon account for more than half the world market for luxury goods. Reuters reported recently that marina developers in Southeast Asia are “racing to build berths to address the latest problem vexing Asia’s rapidly-growing ranks of ultra-rich – insufficient parking lots for their superyachts.”

If you are attracted to the long-term theme of investing in exploding middle classes, focus on Asia.

According to the OECD, between now and 2030 the middle class won't expand at all in the US or Europe and only moderately in Latin America. In Africa there will be substantial growth; in Asia, the middle-class population is set to explode.

"Demographics are superior to those in the West," says analyst Tim Price of PFP Wealth Management, with "younger population motivated to work hard, in large part by the absence of the sort of social safety-net and associated welfare burden that exists in Western Europe."

Tailpieces

Bubble risk: Officials at America's central bank, the Federal Reserve, are worried that the next big financial crisis could be in corporate bonds.

The focus of their fears is bond funds, now a $10 trillion market. They are highly liquid – can readily be cashed in by investors – whereas many of the bonds they hold cannot, in a crisis.

If bond markets take fright at the prospect of rising interest rates, that could trigger a massive disorganized flight of money out of the funds. (And remember… bond market collapses often precede share market collapses).

The Fed is seriously considering imposing exit fees on bond funds to discourage such a flight.

Dividends and buybacks: America's 500 biggest listed companies paid out a record $241 billion in the first quarter – setting a new record above the previous peak in the third quarter of 2007. Corporations have about $1¼ trillion in cash, equivalent to 90 weeks' net income. They're reluctant to spend that cash on expanding their businesses, so they're under increasing pressure to distribute earnings to shareholders.

The *FT* points out: "When buybacks exceed new shares issued, they have the effect of reducing a company's overall share count, thereby lifting its [earnings per share] by having profits distributed across a smaller pool. However, critics argue that the practice can result in a misleading picture of corporate earnings growth."

Where the rich invest: Presumably because they decided to "take profits" out of last year's strong stock-markets, the world's wealthiest investors cut the proportion of equities in their portfolios to below 25 per cent in the first quarter, Capgemini and RBC Wealth Management report in their latest annual study.

They also trimmed their cash holdings to below 27 per cent and real estate investments to below 19 per cent, but increased their exposure to fixed income (bonds and the like) and to alternative investments, especially hedge funds and foreign currencies.

Organic foods: Contrary to what is widely believed, there is no reason to believe that it is safer to eat foods exposed to naturally-occurring chemicals during the processes of growing, harvesting, storage and preparation than to manmade chemicals, Dan Gardner writes in his book *Risk: the Science and Politics of Fear.*

There are probably more than a million such natural chemicals present in food supply.

"Everyone who digs into a delicious meal of all-natural, organically-grown produce is swallowing thousands of chemicals whose effects on the human body aren't fully understood and whose interaction with other chemicals is mysterious.

"Of the natural chemicals that have been tested, one-half have been shown to cause cancer in lab animals. If we were to strictly apply the banned-until-proven-safe approach to chemicals, there would be little left to eat."

Childcare: Its expense has become a major issue for families in North America, Europe and Japan, especially where parents are single, for whatever reasons.

Americans do worst because of absence of benefits and tax concessions. According to the OECD, typical childcare costs as a percentage of net family income for a single-parent family on average earnings, after allowing for benefits/tax, are 41 per cent.

Things are generally better in Europe, mainly because of generous welfare benefits and tax concessions, but vary greatly from country-to-country. Percentage costs are only 6 per cent in Sweden, 7 per cent in the Netherlands and France, but 11 per cent in the UK, 17 per cent in Germany and 51 per cent in Ireland.

Costs are 18 to 19 per cent in Canada and Japan.

Critical decisions: The great majority of active equity fund managers "are terrible at timing when to sell," says the *FT*'s John Authers, yet, after fees, this is the main reason why they fail to beat the index.

Why is selling so difficult?

"Every sale decision will be applied to a stock that at one point we thought it was a good idea to buy. Selling for an underperformance, or especially for a loss, involves admitting a mistake, and crystallizing it for ever. Selling when ahead means crystallizing a gain" – the risk you're being tempted to sell too soon.

A study by research group Inalytics of pension funds showed that good buying decisions improved annual returns by 0.47 percentage points, but selling decisions cost twice as much, 0.94 points, ignoring fees. Good sellers are "a rare breed," says Inalytics.

A regulatory shambles: The Dodd-Frank law designed by American politicians to prevent another major financial crisis is increasingly seen to be a bureaucratic nightmare. The problem, says commentator John Dizard, is that the law "is not a tough set of regulations – it is an impossible set of regulations."

The law is fundamentally flawed in that it gives the Federal Reserve even more power to supervise financial institutions "even though the Fed missed everything that led to the last crisis…

"The mortgage-backed securities that were the detonator of the 2008 crisis were created partly in response to previous master plans generated by Federal regulators." They "were – no kidding – supposed to insulate the banks from excessive risk."

China: Even at a supposedly slow rate of growth of 7 per cent in real terms, it will contribute more than twice as much as the US to this year's growth of the world economy.

Let's stop talking down its economic strength, says Jim O'Neill of Bloomberg.

Many complain that its official statistics are inflated. Partly, such talk “reflects the belief (or hope) that a non-democratic country is bound to fail. Skilled China-watchers are appropriately skeptical,” and took at indicators other than the official ones. “They find that China’s growth is no illusion.”

Much of the slowdown that’s being experienced “is deliberate, part of an effort by China’s government to shape a more sustainable and balanced economy.”

Easy profits: Because of the bizarre environment created by the Fed, US corporate treasurers have enjoyed a no-brainer: borrow money by issuing bonds, then use the proceeds to finance share buybacks. It’s much less risky than making capital investments.

Of course, it doesn’t produce any job creation. But it’s great for executive bonuses.

By reducing the number of outstanding shares, buybacks raise earnings per share even when there is no improvement in revenue or profit margins. Commentator John Plender says this “leads to bonuses and other equity-related incentives based on performance yardsticks such as earnings per share and return on equity that bear no strict relation to value creation.”

Orient looks good: Although investors should not expect the Southeast Asian economies to grow at the hyperactive rates achieved by China in recent decades, the region does have the potential to take over from China as the lowest manufacturing-cost centre in Asia, says NT Asset’s Kenneth Ng.

“The right ingredients are certainly there for long-term sustainable growth: young demographics, rising middle-class and consumer spending capability, urbanization drive, low labour cost and generally hardworking labour.”

Less drilling for oil: Companies such as Seadrill and Transocean that provide rigs for deep-water offshore exploration are being hit by cutbacks by oil giants squeezing their capital spending to improve their earnings and dividend-paying capabilities.

“Deep-water projects are expensive,” reports the *WSJ*. “On average, renting a deep-water rig costs roughly half-a-million dollars a day – about five times the rate for a rig used in shallow areas of the Gulf of Mexico.”

Worrying figures: Total debt of the US government has topped $17½ trillion, and of course it’s still growing fast. In its budget for fiscal 2014 the administration estimated outlays of $3.8 billion but receipts of only $3 billion, leaving a gap of $744 billion to be financed through borrowed money.

Wise words: *If you buy things you don’t need, you’ll soon have to sell things you do need.* Warren Buffett.

Martin

Know someone you’d like to receive ►On Target ? Click on Reply and send me his/her email address. Or email your request to me at: afrodyn@gmail.com.