►On Target

Martin Spring's private newsletter on global strategy

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Planning How to Outperform the Experts

Last month I argued for partly or entirely managing your investment portfolio (as I have done for half a century), rather than relying on professional managers.

You don't have to make repeated and difficult decisions such as what to buy or sell and when to do so. You could simply use a formula plan, as I described two years ago, with fixed proportions of different assets requiring no more than periodic rebalancing. That's an easy, low-risk way to secure and grow your personal wealth.

But if you want a more hands-on, actively managed approach – which could bring you higher long-term returns, gives you more of a feeling of controlling your destiny, and is certainly more interestimg – how should you go about it?

You must have an investment plan, one based on a particular style that appeals to you, such as value, growth, contrarian or momentum investing.

You need to stick to the discipline of a system – but only if it works for you. If it doesn't, scrap it and switch to a different one.

Benjamin Graham, the founder of securities analysis, changed his stock-picking criteria several times. He warned that investment theories often cease to work, and that even good theories do not work in all market conditions.

Pick a system that plays to your strengths. After a few years of experimentation, you'll discover what you're reasonably good at – and what kinds of investing you should avoid because you don't have the skill, knowledge or intuition for them.

Graham believed that if you buy a company cheaply enough, you won't lose money even if your expectations of profit aren't fulfilled.

Never invest in a share or a fund that you don't understand.

Here are some other useful tips on successful investing from my friend Bruno Bandulet, the well-known German adviser:

Don't put all your money on a single bet. By spreading your risk across several investments, you reduce the average risk of your portfolio.

Five to seven shares should be the minimum number of your core holdings of equities. If you want to go into mining exploration, small-cap or other high-risk shares, plan on holding ten to 20. The more you have, the better your chances of hitting a bull's-eye with one of them.

Always expect surprises. An investment seldom takes the course you expect it to when you bought it. Surprises are the norm – pleasant as well as unpleasant ones.

No financial market is predictable, and there is no such a thing as long-term secure investment. Prognoses can be no more than intelligent hypotheses which must be continually re-examined for correctness.

Lack of certainty is what gives investing its excitement.

Even if you are right, you are usually too early, as price trends often hold longer than expected.

Be sceptical about readily-available information. Be wary, not only of reports published in the media, but also of research by banks and stockbrokers.

The quality of the latter has dwindled in recent years and the conflicts of interest have become very apparent, such as promotion by banks of shares of companies that are often important clients.

Always look first at the chart. Charts offer the most information concentrated into a small space – they are comprehensive, easy-to-read presentations of rows of figures.

There is no better method of getting to know the price history of a share or asset class, and you must know that before making any decision about it.

Whether an investment has been rising or falling for months, whether it can obviously not rise or fall further, whether it has performed better or worse than comparable investments – all these factors must be examined before you make a decision.

You don't need to understand or apply any complicated charting theories – just use commonsense.

You must be able to sell. Shares move in cycles, so you must be prepared to take your profits or to cut your losses. There will always be other interesting opportunities.

If you don't know what to do about a share you're holding, better to sell it.

If your share shows a really good profit, especially if it's something volatile such as a gold exploration company, as the risk of a setback is now greater at the higher price level, sell half.

Keep money in reserve. You should always have a war chest to snap up shares you have held off buying because they were too expensive, if their prices have fallen – provided of course that your original reasoning is still valid.

However, buying more of a share you hold merely to lower average cost of purchase is a mistake.

Beware of price illusions. Low-priced shares do often have greater potential, but their risk is also greater. A 10c share may look very cheap, but a drop to 8c would cost you as much money in percentage terms as a fall in a dollar share to 80c. And a 50 per cent loss on an exploration share costing $2 happens faster than the halving of a heavyweight mining share costing $20.

Get the right partner. If your stockbroker or bank can't provide prompt and efficient service to do the deals for you, find one that can.

Forget about taxes. Don't let tax considerations override investment considerations, which should always be paramount.

"Things are different now". This is the silliest of quotations. In 1980 it was said "gold can only go upwards now," but just two years later it was said "the action is dead". Over the long term we see history's lessons repeated.

Conclusion?

The doing-it-yourself alternative to professional management isn't an easy one.

It requires considerable knowledge, which can only come from a lot of reading and hands-on practical experience and the time to acquire it.

It also requires enough personal self-confidence to take decisions that conflict with the current consensus, enough courage to embrace risk while avoiding speculative extremes.

If doing-it-yourself were easy, everyone would be doing it, wouldn't they?

The Outlook for Key Issues

Three big issues are likely to dominate investment markets next year – economic growth, inflation and currencies.

Growth is important not so much for itself as for how policymakers, particularly central bankers, react to it. If growth disappoints, you can expect to see more aggressive easy-money policies, with the Fed (the US central bank) being more cautious about raising interest rates.

Consumer demand in the major economies is likely to remain stable. In the US employment growth can be expected to keep employee earnings in their gently-rising trend, so families should have a little more to spend. The continuing explosive growth in China's middle class that is fuelling an 11 per cent annual growth in retail spending in real terms will offset consumer weakness elsewhere in the emerging economies.

The big problems for economic growth lie in other sectors:

► There is little or no growth in world trade, which has been hit hard by the collapse in prices of energy resources and industrial metals. This is partly due to over-supply after heavy investment in mining and oil/gas wells to expand production.

But it's also due to structural changes in economic activity away from products requiring processing of bulky materials towards knowledge-intensive products (mobile phones rather than housing), and from manufacturing to services.

Neither of those negative factors is going to disappear quickly.

► Investment in the future is depressed by lack of business confidence, governments' financial constraints, and consumer caution about taking on debt.

Most of that is fall-out damage caused by the global financial crisis and the foolish way ruling elites addressed it, but in Europe there are additional geo-political factors -- the disunity of the region's governments, alienation of voters, escalating conflict with Russia, jihadist terrorism and an avalanche of migrants.

Elsewhere… who knows? The Donald Trump phenomenon is not an encouraging sign.

The consensus of economists is that global economic growth will be stronger next year. But I fear the risks, mainly geo-political, are on the downside – of setbacks rather than disasters.

Inflation is something that policymakers want badly because it makes it easier for them to solve problems… or at least to mask their failures to do so. Investors tend to favour it, too – probably unwisely.

For years central bankers have been setting themselves targets such as annual inflation of 2 per cent, and repeatedly failing to achieve them. For years most investment advisers have been saying that things are going to change, that the flood of easy money will turn things around and bring inflation. And they have also been consistently wrong.

This has been a year, as one analyst puts it, "dominated by tumbling inflation" and "talk of secular stagnation." The best investment asset class has been government bonds, and the worst, commodities. Equities did nothing. Who predicted that?

A false dawn next year?

Next year, several factors may "improve" the outlook for inflation. As the months progress, current price levels are likely to look relatively better against those 12 months before – a statistical aberration that can easily mislead.

Before the end of the year we could well see a sharp bounce in prices of oil (which is by far the most important commodity) as negative factors such as supplies from Iran are overtaken by positive factors such as cuts in high-cost output from shale wells.

Nevertheless, it's hard to see a fundamental reversal coming soon in the medium-term disinflationary trend.

Currencies are a war zone all of their own. Sometimes they're used by governments to promote economic growth (encouraging exports and discouraging imports), most obviously by Japan. At other times, governments are helpless as big money flees from their incompetence – Brazil is a current example.

The US dollar is the foundation of the global financial system, so it's how other currencies measure against the greenback that matters most. The euro plunged last year, but has moved sideways this year. The Chinese yuan has been falling for almost two years, the Japanese yen for more than three.

Clearly the most important reason for this is opposing policy positions. The Fed has been moving slowly away from its easy-money policies, halting quantitative easing and edging towards higher interest rates. The central banks are pursuing aggressive easy-money policies (it's easier for the Asians to do that than for the European Central Bank, which operates with greater legal and political restraints).

That makes US assets, especially financial deposits, more attractive to international investors, while the rest face headwinds.

The disparity in central bank policies seems likely to persist.

Whether that's good or bad news depends what you invest in. A Japanese exporter could benefit from making greater sales of its cheaper product, but its dividends and shares priced in yen will be worth less if you're a foreign investor. An American company earning a lot outside the US will experience downside pressure on its earnings, but what they pay you as a part-owner will be in the world's strongest major currency.

Isis: Empty Threats and Empty Heads

The developing crisis in the Mideast focused on Isis can only get worse. Governments are doing a great deal of posturing about destroying this radical movement following its Paris terrorism, but dropping more bombs from a handful of French and British planes is nothing more than posturing.

It's clear that Isis cannot be defeated without large-scale urban warfare. The major city it controls, Mosul, is reported to be a fortress reinforced by networks of trenches, tunnels and minefields, defended by thousands of fanatics prepared to be suicide bombers and use children as shields.

Destroying Isis will require massive "boots on the ground" that no one is prepared to commit.

What's more, none of the nations indulging in empty posturing is prepared to address the fundamental issues that will have to be faced when Isis is eventually defeated.

► Who will provide the massive semi-permanent army needed to occupy the territories liberated from Isis?

► How will those territories be governed? By some nasty bunch of religious fanatics, by corrupt and self-perpetuating elites with the guns and money, or (hopefully) via power structures closer to regional semi-secular models such as Israel, Turkey?

► How will peace and reconciliation be brought to communities deeply divided by religion, race, intervention by foreign meddlers, and a new heritage of death and persecution?

Both Syria and Iraq are artificial countries created by Britain and France out of the defeat of the Turkish empire in the First World War. Those "great powers" of the time forced together populations without any united sense of nationality.

No solutions to Isis and the fundamental causes that spawned it are possible without first recognizing what every informed observer knows, but no government even wants to discuss – that both Syria and Iraq have to be broken apart.

Their territories need to be reshaped into four countries based on largely homogeneous populations – a fully independent Kurdistan; a truncated Western Syrian homeland for the Alawites, Christians and other non-Sunni minorities; a new state embracing the overwhelmingly Sunni-populated areas of Iraq and Syria now controlled by Isis; and a Shia-dominated rump of Iraq.

One important reason why it's going to take a long time before that happens is that Turkey, probably the most important of the nations interfering in the Mideast to advance their own interests, is bitterly opposed to an internationally – recognized, fully-independent Kurdistan. The Turks fear that would strengthen the political power of their Kurdish minority, the threat of terrorist violence by Kurds… and the pressure to cede Kurdish-populated parts of Turkey.

Nations' foolish obsession

Here we get to a fundamental problem facing solution of most of the world's nasty local conflicts involving ethnic or religious minorities – the refusal of all governments to abandon their obsession with territorial integrity.

Partition, which violates that concept, only comes about in extreme circumstances such as collapse of empire. Never as a planned and acceptable, permanent answer to fundamental social conflicts.

Yet territorial integrity is a ridiculously archaic concept from the Middle Ages based on the economic and strategic importance of land areas before wealth and military power became dependent on human capital, industrial resources and technology – as demonstrated spectacularly by highly successful small nations and citi-states such as Switzerland, Israel and Singapore.

Where minorities predominate in clearly definable regions, they should be allowed to choose, should they wish, independence, or integration into some appropriate neighbouring state, taking their bits of land with them.

Unfortunately, no nations yet have any interest in that idea. They will continue to be willing to sacrifice blood and treasure to hold on to their bits of real estate of negligible value, cultivating the hatred of minorities against what they perceive to be oppression, or even offer up their own blood and treasure in abortive attempts to break free.

Defeating Isis is itself going to be a herculean task. Rebuilding decent societies afterwards will be even harder, and require much courageous planning. Surely we've now learned that lesson after the shambles the US and its allies brought about in Iraq and Libya, and are now contributing towards in Syria?

Airport Security? Don't Make Me Laugh!

By Robin Mitchinson*

About 57 years ago I embarked on my first long-haul flight, from Gatwick (England) to Salisbury, Rhodesia.

I arrived at the terminal, a large Nissan hut left over from the war, which was the totality of Gatwick Airport in those days. I presented my ticket, checked in my bag, passed Immigration with scarcely a cursory nod from the officer, and ambled on to the aircraft; elapsed time – ten minutes maximum.

Since that time I have criss-crossed the world and logged hundreds of passenger-hours. My last (and it almost certainly will be, now that air travel has ceased to be a mildly pleasurable adventure and become a deeply unpleasant ordeal), was from the Isle of Man to Gatwick, taxi to Heathrow, flight to Bangkok and finally to Chiang Mai, Thailand.

That entailed three passes through 'security'. And it's a cruel farce. Jacket off, shoes off, belt off, laptop out. A tube of toothpaste is discovered in my carry-on. Out it goes. Then the aftershave.

Never mind the 'sharps'. Woe betide you if you are found concealing nail scissors. Quite how you could hijack a 747 thus armed is a secret known only to 'them'.

A while back there was an amusing letter in the *Telegraph* from an airline captain who recounted how this very thing happened to him. When he got into his seat at the business end of his jumbo, he was sitting next to the fire axe. In response, an airport policemen recounted how they also have to go through the identical checks while armed to the teeth with sub-machine guns, Tasers, tear gas and handcuffs.

But we can all acquire a handy weapon quite legally and openly -- a smashed litre bottle bought in Duty Free or on-board might do rather more damage than nail scissors.

The simple answer is for all duty-free liquor to be sold in plastic bottles, as they are in the bonded store. Much less weight also, although the contents will be just as flammable, which suggests duty free sales ought to be at 'arrivals' instead of 'departures'.

Which brings us to the nonsense of liquids.

Scientists will say that it is impossible to manufacture a bomb from liquids whilst sitting in an economy-class seat (or anything else for that matter). The liquids ban is a fiction. Nobody has ever been detained for carrying suspicious liquids. And nobody has ever been detained as a result of removing their shoes!

None of this rigmarole has much to do with anti-terrorism. But in the wake of recent events, stand by for the politicians to start waffling about 'increasing airport security even if this means more delays at check-in'. Those are the words of the UK Foreign Secretary. And yet the TSA security agency has an annual budget of $7 billion without detecting a single terrorist in ten years.

The security systems are a bad joke. In undercover operations, Department of Home Security inspectors got fake bombs and firearms through the screening process in 67 out of 70 tests.

Passengers ought not to be prime suspects in terrorist threats. Baggage handlers should be high on the list, since they have no difficulty in opening passenger bags to steal valuables (30,000 reported cases in the US last year).

The simple truth is that airport security has never played a role in frustrating terrorist attack plans; all have been the result of good intelligence.

There is a solution, one which I advocated at least a year ago, and that is to follow best practice as demonstrated by El Al. I have a friend who does consultancy assignments in Gaza, which means frequent air travel via Israel. He has never had a problem; security clearance is swift and thorough with minimum inconvenience to passengers,

So how do they do it?

This is where the evil of PC rears its ugly head elsewhere.

Instead of looking for weapons, the Israelis look for suspects, and this means profiling. Hebrew-speaking Israelis get scant attention. A woman in a burka might warrant rather more, but not necessarily. The El Al approach is not based on stereotypes but on psychological observation.

Insider threats are a particular danger; it is pretty certain that if the Sinai disaster was caused by a bomb, the most likely culprits will be airside workers – cleaners, refuellers, marshallers, etc. It was certainly not a passenger!

The whole airport security structure is an unfunny farce designed to deceive us into believing that 'something is being done' when it is nothing more than theatre.

* *From his blog: www.whydonttheylistentous.blogspot.com*

Tips from Top-Performing Managers

Terry Smith, whose relatively new Fundsmith global equity fund is one of the UK's very best performers, offers this advice to investors:

► Ignore the general obsession with macroeconomics, interest rates, quantitative easing, asset allocation, geographic allocation, currencies, developed versus emerging markets – "questions to which no one can reliably forecast the answers" – and focus on investing in good companies.

► Stick to your guns and ignore popular opinion. "I lost count of the number of times I was asked why we didn't own Tesco shares, or that I was told that I had to own Tesco shares, when our analysis showed quite clearly that its earnings-per-share growth had been achieved at the expense of returns on capital."

► Currencies are one of the least well-understood investment subjects. A company's currency exposure is not determined by where it is headquartered, or listed, or in which currency it denominates its accounts. One example of fallacious reasoning: believing that Nestlé would benefit from a rise in the Swiss franc, when 98 per cent of its revenues arise outside Switzerland.

► Examine companies' actual accounts and don't rely on management presentations of figures which often present "underlying," "core" or "adjusted" numbers. Such adjustments "almost always seem to remove negative items."

► Selling good companies that you own is rarely a good move. Run your winners. Cull your losers. “Gardeners nurture flowers and pull up weeds – not the other wary around.”

And here are some additional guidelines for you to follow based on advice given by the legendary American investment analyst and commentator Bob Farrell:

► Markets tend to return to the mean over time. When stocks go too far in one direction, they revert. Euphoria and pessimism can cloud your thinking. It’s easy to get caught up in the heat of the moment and lose perspective.

► But also… Excesses in one direction will lead to an opposite excess in the other direction.

► There are no “new eras” – as a fever takes hold, a chorus of “this time it’s different,” or something similar, will be heard. Whatever the latest hot sector, it eventually overshoots, mean-reverts and overshoots in the opposite direction. Human nature is never different.

► Rapidly rising or falling markets usually go further than you think, but they do not correct by going sideways.

► The public buys most at the top and least at the bottom. That’s why contrarian-minded investors can make good money if they follow sentiment indicators and act counter-trend.

► Fear and greed are stronger than long-term resolve. Investors can be their own worst enemy when they allow their emotions to take hold.

► Markets are strongest when they are broad and weakest when they narrow to a handful of blue-chip names. Watch for when momentum has become channelled into a small number of stocks.

► Bear markets have three stages – a sharp fall, a reflexive rebound, then a drawn out downtrend.

► When all the experts and forecasts agree, something else is going to happen. Going against the herd can be very profitable for patient buyers who raise cash from frothy markets, then reinvest it when sentiment is darkest.

The Nifty Nine

Although American shares as a whole look as though they’re going to end the year about where they started, some analysts worry that lack of “breadth” suggests ominous underlying weakness in the market.

That general weakness has been disguised by strength in just a handful of big stocks. Ned Davis Research calls them The Nifty Nine – Amazon, Ebay, Facebook, Google, Microsoft, Netfix, Priceline, Salesforce and Starbucks. By the end of last month their prices were up 60 per cent for the year, against just 1 per cent for S&P 500 stocks as a whole.

It’s argued that their strength shows how economic growth is increasingly focused on services rather than manufactures. Even Microsoft is redirecting its resources from product (Windows) to Web services; Starbucks is much more about beverage services than it is about coffee beans.

Nothing wrong with that. However, as some point out, hype and excitement about a handful of big companies, at a time when the shares of the small companies that are typically the leaders of economic growth are struggling, are classic symptoms of the top of a bull market.

Markets Trapped in Secular Stagnation

Currently the most widely-held investment positions include "bonds, boring companies with safe dividends, new technologies able to grow whatever the economy does, and a broad range of higher leverage and more buybacks," says the *FT*'s James Mackintosh. That's because of the widely-held belief that we're in a period of secular stagnation – mediocre economic growth with little inflationary pressure.

However, economic forecasts may be too pessimistic. "After a great run, the best days for these investment ideas may be behind us."

For a very different and unconventional approach, here's what PFP Management's investment director Tim Price has to say…

"We're not blithely tracking stock indices, or surfing overpriced mega-cap consumer brands that, one by one, are being taken to the woodshed and shot, courtesy of some rather painful Chinese-led deflationary pressure.

"Since our central banker friends are working hard to discredit cash, we see unusual merit in only the highest-quality, most inexpensive, listed businesses (Japan and Vietnam being among the cheapest sources of such companies). And in healthy amounts of portfolio protection – systematic trend-followers in terms of uncorrelated insurance, and precious metals in terms of systemic and inflation insurance."

High Charges from Closet Trackers

Research in Europe and the US has shown that in at least 20 of the world's largest investment markets investors are being charged for "active" management in funds that do no more than minimal-cost index tracking. Carl Rosen of the Swedish Shareholders Association says this is a "gigantic mis-selling phenomenon."

In Sweden itself and in Poland, more than half the assets in domestic equity funds have been funnelled by intermediaries such as large banks towards managers who charge high fees for "active" management, but in practice closely follow the indexes. The practice is almost as widespread in Canada, Finland and Spain. It's least used in the US, but even there still accounts for 15 per cent of the local equity products base.

Rosen says regulators should ban all active funds that charge fees of more than 0.8 per cent, have a low tracking error, and have high compatibility with benchmark indexes.

Hoovering up the Wealth

"For most Americans, real income levels have flatlined for a generation," reports Paul Tudor Jones. Most of the benefits of economic growth have been flowing to those who are already rich. In 1980 the average chief executive made about 42 times more than the average employee. Today that ratio is about 373 to one.

"Adding to the distress is the fact that employees are seeing cuts in programmes related to health, retirement and other benefits as companies strive to lower costs."

Another disturbing trend is that businesses are increasingly investing less in the future – in expansion. research and development – instead distributing profits to shareholders and executives. In 2014 America's 500 biggest listed companies bought back $553 billion of their own shares, or twice as much as they spent on R&D.

Credit Risks

There are five reasons to worry as the US central bank embarks on its course of raising interest rates, it's argued:

► Growth in corporate earnings has disappeared and analysts have been cutting their estimates of future profits.

► Growth in sales revenues has also disappeared, and falling at a rate only seen during recessions in recent years.

► The gap between yields on the safest bonds and riskier credits is widening, particularly those for energy businesses and private equity.

► Borrowings to finance share buybacks and mega-mergers are back to levels seen just before the 2007 credit crisis.

► Default rates are rising – a tenth of energy junk bond issues have defaulted in the past year.

Tailpieces

Commercial property: The climate is "less helpful" now because pension funds consider its illiquidity make it less attractive than bonds and blue-chip equities, but by contrast it's benefiting from the huge build-up of capital in Asia and petro-economies, channeled through sovereign wealth funds, John Plender reports in *FTfm*.

There's been a "stampede into trophy office buildings in top global cities," but that has polarized the market between assets regarded as most desirable, and the rest. The gap between yields on government bonds and on non-trophy properties has become so wide that it could trigger a tidal wave of private capital into such assets.

In the UK it's estimated that the investment property universe is less than one-quarter the size of the equities market.

Japanese companies : The shareholder return ratio in Japan currently stands at 37 per cent a year – derisory compared either to Europe (71 per cent) or the US (83 per cent." But the good news is that investors are likely to get a bigger share in future. Both dividend payments and share buybacks as a percentage of profits in

Japan are already on the rise, and have plenty of room to catch up towards Western levels.

One analyst says: “The managers we invest with in Japan report that the change in Japanese corporate behaviour, especially among mid-cap businesses, is real. Since Japan also offers us highly profitable companies on PE ratios of around 10x and price/book ratios of around one, we simply don’t need to overpay to own the US market.”

Genetic foods: In China, a biotech company has announced that it’s going to build the world’s largest animal cloning factory, eventually to produce a million head of cloned cattle a year to meet exploding demand for high-quality beef. (Animal cloning is permitted in the America as well as China, but not in Europe)

In the US it’s taken nearly a quarter-century of delays and controversy, but at last the Food & Drug Administration has approved cultivation and consumption of a genetically modified fish developed by a Japanese scientist. It’s a salmon that grows to marketable size in half the time it takes an ordinary specimen to do so.

The dollar: History suggests it’s probably going to be weak – not strong, as generally expected – if the Fed starts raising interest rates this week.

Credit Suisse says that in the five interest-rate cycles of the past 30 years, the greenback gained almost 3 per cent on a trade-weighted basis in the months leading up to the first rate increase, but slid an average of more than 5 per cent in the following year.

Forecasting: “Economists have wrongly predicted an accelerating American economy and a bear market in Treasury bonds every year since the recovery began in mid-2009,” says CLSA’s Christopher Wood.

He also points out that for more than two years Europe’s economic growth rate as measured by GDP, in both nominal and real (inflation-adjusted) terms, has been rising, while America’s has shown no pick-up.

Grounds for discrimination: The European Investment Bank is advertising a senior position. It boasts: “We promote and value diversity and inclusion among our staff and candidates, irrespective of their gender, age, nationality, race, culture, education and experience, religious beliefs, sexual orientation or disability.”

Can you see what’s missing? Any commitment to ignore applicants’ political beliefs.

Wise words: *Those who have knowledge don’t predict; those who predict don’t have knowledge*. Lao Tzu, a 6th century Chinese philosopher.

I wish you all a healthy and prosperous New Year.

Martin

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