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Road to nowhere

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- Spring 2010: A gradual recovery
- Autumn 2010: A gradual and uneven recovery
- Spring 2011: European recovery maintains momentum amid new risks
- Autumn 2011: A recovery in distress
- Spring 2012: Towards a slow recovery
- Autumn 2012: Sailing through rough waters
- Winter 2012: Gradually overcoming headwinds
- Spring 2013: Adjustment continues
- Autumn 2013: Gradual recovery, external risks
- Winter 2013: Recovery gaining ground
- Spring 2014: Growth becoming broader-based
- Autumn 2014: Slow recovery with very low inflation.. "

- European Commission economic headlines, as highlighted by Jason Karaian of Quartz, in 'How to talk about a European recovery that never arrives'.

"Well we know where we're going
But we don't know where we've been
And we know what we're knowing
But we can't say what we've seen
And we're not little children
And we know what we want

And the future is certain
Give us time to work it out
We're on a road to nowhere.."

- 'Road to nowhere' by Talking Heads.

In 1975, Charles Ellis, the founder of Greenwich Associates, wrote one of the most powerful and memorable metaphors in the history of finance. Simon Ramo had previously studied the strategy of one particular sport in 'Extraordinary tennis for the ordinary tennis player'. Ellis went on to adapt Ramo's study to describe the practical business of investing. His essay is titled 'The loser's game', which in his view is what the 'sport' of investing had become by the time he wrote it. His thesis runs as follows. Whereas the game of tennis is won by professionals, the game of investing is 'lost' by professionals and amateurs alike. Whereas professional sportspeople win their matches through natural talent honed by long practice, investors tend to lose (in relative, if not necessarily absolute terms) through unforced errors. Success in investing, in other words, comes not from over-reach, in straining to make the winning shot, but simply through the avoidance of easy errors.

Ellis was making another point. As far back as the 1970s, investment managers were not beating the market; rather, the market was beating them. This was a mathematical inevitability given the over-crowded nature of the institutional fund marketplace, the fact that every buyer requires a seller, and the impact of management fees on returns from an index. Ben W. Heineman, Jr. and Stephen Davis for the Yale School of Management asked in their report of October 2011, 'Are institutional investors part of the problem or part of the solution ?' By their analysis, in 1987, some 12 years after Ellis' earlier piece, institutional investors accounted for the ownership of 46.6% of the top 1000 listed companies in the US. By 2009 that figure had risen to 73%. That percentage is itself likely understated because it takes no account of the role of hedge funds. Also by 2009 the US institutional landscape contained more than 700,000 pension funds; 8,600 mutual funds (almost all of whom were not mutual funds in the strict sense of the term, but rather for-profit entities); 7,900 insurance companies; and 6,800 hedge funds.

Perhaps the most pernicious characteristic of active fund management is the tendency towards benchmarking (whether closet or overt). Being assessed relative to the performance of an equity or bond benchmark effectively guarantees (post the impact of fees) the institutional manager's inability to outperform that benchmark – but does ensure that in bear markets, index-benchmarked funds are more or less guaranteed to lose money for their investors. In equity fund management the malign impact of benchmarking is bad enough; in bond fund management the malign impact of 'market capitalisation' benchmarking is disastrous from the get-go. Since a capitalisation benchmark assigns the heaviest weightings in a bond index to the largest bond markets by asset size, and since the largest bond markets by asset size represent the most heavily indebted issuers – whether sovereign or corporate – a bond-indexed manager is compelled to have the highest exposure to the most heavily indebted issuers. All things equal, therefore, it is likely that the bond index-tracking manager is by definition heavily exposed to objectively poor quality (because most heavily indebted) credits.

There is now a grave risk that an overzealous commitment to benchmarking is about to lead hundreds of billions of dollars of invested capital off a cliff. Why ? To begin with, trillions of dollars' worth of equities and bonds now sport prices that can no longer be trusted in any way, having been roundly boosted, squeezed, coaxed and manipulated for the dubious ends of quantitative easing. The most important characteristic of any investment is the price at which it is bought, which will ultimately determine whether that investment falls into the camp of 'success' or 'failure'. At some point, enough elephantine funds will come to appreciate that the assets they have been so blithely accumulating may end up being vulnerable to the last bid – or lack thereof – on an exchange. When a sufficient number of elephants start charging inelegantly towards the door, not all of them will make it through unscathed. Corporate bonds, in particular, thanks to heightened regulatory oversight, are not so much a wonderland of infinite liquidity, but an accident in the secondary market waiting to happen. We recall words we last heard in the dark days of 2008:

"When you're a distressed seller of an illiquid asset in a market panic, it's not even like being in a crowded theatre that's on fire. ***It's like being in a crowded theatre that's on fire and the only way you can get out is by persuading somebody outside to swap places with you***."

The second reason we may soon see a true bonfire of inanities is that benchmarked government bond investors have chosen collectively to lose their minds (or the capital of their end investors). They have stampeded into an asset class historically and euphemistically referred to as "risk free" which is actually fraught with rising credit risk and systemic inflation risk – inflation, perversely, being the only solution to the debt mountain that will enable the debt culture to persist in any form. (Sufficient economic growth for ongoing debt service we now consider impossible, certainly within the context of the euro zone; any major act of default or debt repudiation, in a debt-based monetary system, is the equivalent of Armageddon.) As Japan has just demonstrated, whatever deflationary tendencies are experienced in the indebted western economies will be met with ever greater inflationary impulses. The beatings will continue until morale improves – and until bondholders have been largely destroyed. When will the elephants start thinking about banking profits and shuffling nervously towards the door ?

Meanwhile, central bankers continue to waltz effetely in the policy vacuum left by politicians. As Paul Singer of Elliott Management recently wrote,

"**Either out of ideology or incompetence, all major developed governments have given up (did they ever really try?) attempting to use solid, fundamental policies to create sustainable, strong growth in output, incomes, innovation, entrepreneurship and good jobs.** The policies that are needed (in the areas of tax, regulatory, labour, education and training, energy, rule of law, and trade) are not unknown, nor are they too complicated for even the most simple-minded politician to understand. But in most developed countries, there is and has been complete policy paralysis on the growth-generation side, as elected officials have delegated the entirety of the task to central bankers."

And as Singer fairly points out, whether as workers, consumers or investors, we inhabit a world of "fake growth, fake money, fake jobs, fake stability, fake inflation numbers".

Top down macro-economic analysis is all well and good, but in an investment world beset by such profound fakery, only bottom-up analysis can offer anything approaching tangible value. In the words of one Asian fund manager,

"The owner of a[n Asian] biscuit company doesn't sit fretting about Portuguese debt but worries about selling more biscuits than the guy down the road."

So there is hope of a sort for the survival of true capitalism, albeit from Asian biscuit makers. Perhaps even from the shares of biscuit makers in Europe – at the right price.

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