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A cautionary tale

"Bristol Crown Court heard how almost 10,000 people booked to visit the brothers' Lapland New Forest attraction.. in the run-up to Christmas 2008. They were lured by promises of a "magical tunnel of light", a "bustling Christmas market" filled with log cabins covered in snow, and Father Christmas himself at the centre.. But instead of entering through the gates of a place "where dreams really do come true", visitors found themselves driving down a potholed lane past a rusting pile of scrap cars guided only by a traffic cone with a piece of paper on top, the court heard. Rather than being welcomed by elves, they were met by men in high visibility jackets collecting ticket stubs and directing them to a muddy car park. Inside, the promised "magical tunnel of light" turned out to be a row of fir trees with patio lights strung between them.. In the event, the ice rink was continually out of order, resembling what one visitor described as "two puddles". Local trading standards officers were flooded with complaints from disappointed families and media reports featuring disgruntled elves smoking cigarettes."

- 'Lapland theme park brothers guilty of dishonesty', John Bingham, The Daily Telegraph, 18 February 2011.

These are testing times for investors. Look beyond the headline stock index returns – in no small measure fuelled by unsustainable monetary stimulus – and the underlying market environment "feels" unhealthy. There is no shortage of cracks in the artifice of apparent stability to write about. Cash deposit rates remain pitifully low for savers, heavily outweighed by rising food and energy prices. Those same energy prices are likely to remain elevated but in a context of broader volatility given the revolutionary fervour sweeping through North Africa and the Gulf states. Small businesses continue to complain of being starved of capital by the banks. Here in the UK, the electorate is bracing itself for the impact of swingeing cuts in government spending, in the aftermath of raised consumption taxes. Further afield in the western economies, and not least in the US, governments remain in denial about the increasingly urgent requirement to bring their budgets back even vaguely towards balance. And yet the markets continue to rise.

The pragmatic investor is now forced into an uneasy compromise. In recognition of the fact that the game has changed, at least for the moment, he or she is obligated to take on extra risk simply in pursuit of preserving the value of their portfolio in real terms, let alone expanding it. This nuance appears to have been lost by the FT's John Authers, who this weekend was finally able to argue in defence of the role of active managers versus passive trackers. With all due respect to Mr. Authers, he frames the debate in overly simplistic terms. It is not just down to whether investors have a better chance of beating the market through active fund management or passive vehicle selection. Some investors, ourselves included, have no real interest in beating the market as a fundamental objective – we "simply" want to beat inflation, and generate a meaningful real return into the bargain if we can. We do, however, have a sneaking suspicion that a long run consisting of short run periods of absolute returns stands a good chance of beating the market over the longer term, but that is not the primary objective. The dilemma of our times is that even this, more humble, objective of capital preservation in real terms has been made essentially impossible courtesy of government manipulation of asset prices (via extraordinarily low and inflationarily stimulating monetary policy rates, and the seemingly magical "wealth creating" deployment of quantitative easing). We need, in other words, to take risk in order to avoid it.

Risk-taking naturally comes at a price. For many, that price may now be too much to bear. A friend in Australia writes as follows:

"I seem to be having an investor's nightmare which I am unable to wake from, and I'm beginning to worry that it might be real after all. For many months I have been an enthusiastic seller of stocks and commodities..

"..I have been caught out by QE2 [the latest round of quantitative easing announced by the Federal Reserve, which may yet be followed by QE3 and QE4] and the smothering of the US dollar.. In addition I have built a huge short fund, that is continuously losing money. As a result my fund has been very badly hit by the recent surge in most asset classes, and I am not only nursing financial (paper) losses, but also emotional distress and psychological torture as well. It is as if the markets were watching my every move and my every decision, and then moving against me to inflict increasing pain in every way possible..

"The emotional and psychological effects of these experiences have surprised me. I have pretty much fallen apart; I am depressed; I have not slept well for several months (and now I'm on sleeping tablets). My attitude to money has changed; previously I didn't much care about the cost of things and had little desire to live extravagantly..

"I thought I should also share this story with you, as it might be helpful for your own perspective and feel free to use me as a "cautionary tale" for other would-be risk takers you might come across.."

In addition to offering well-meant sympathies, we suggested considering an alternative approach to trading the market (if indeed ongoing trading was deemed an appropriate course): rather than adopt a discretionary, subjective strategy of pre-empting market trends, why not adopt a reactive one – of allowing price action itself to dictate a trading response, whether to hitch a ride on the trend or not, if said trend exists. To non-traders, the idea of passively following a trending market (for as long as that trend persists) may seem ridiculously simplistic, not to say foolish. The very success of systematic trend-following as a profitable trading approach may lie in its simplicity. It requires no skills in market forecasting whatsoever. It does, however, require a disciplined approach to risk management – not least in position sizing, and the unflinching willingness to obey the rules of whatever systematic approach one adopts – and then the patience to see that strategy through. For more on trend-following, visit the excellent resource that is Turtle Trader.

But we are not traders (though we are happy to invest some our capital with good trend-followers). Instead, we do make subjective, discretionary (non-system-based) assessments of the attractions of various asset classes, and then try and identify the most appropriate vehicles to extract the highest risk-adjusted returns from those markets. As stated previously, we're expressly not trying to beat the market – not least because we view sustained market directional forecasting as impossible. Rather, we're trying to capture some of the returns from sensibly valued asset classes whilst simultaneously preserving capital as far as that's possible.

As our friend in Australia has learnt at some cost, it can be a painful experience going head-to-head with an accommodating central bank, whatever the economic fundamentals. There is a reason why the expression "Don't fight the Fed" holds such sway in the marketplace. But not even the Federal Reserve can keep a market aloft beyond the realms of sanity forever. One line in our correspondence leapt out:

"It is as if the markets were watching my every move and my every decision, and then moving against me to inflict increasing pain in every way possible."

That might be the best definition we have heard so far about the market, let alone a market under the malign spell of quantitative easing and central bank manipulation. For traders, the trick has to be to maintain a sufficient buffer of cash or liquidity to weather the storm until the inexorable gravity of fundamentals can reassert its primacy over the monetary printing press.

In the cause of capital preservation in real terms, last week we mentioned the unedifying bullying of the Dutch regulator when faced with a pension fund holding some of its assets in gold. This week, the rot spreads further; Zero Hedge reports on a bill proposed in Washington that would require any purchaser of gold to the value of more than $100 to give details of their name, date of birth, sex, height, race, address and telephone number. A year ago, a Swiss fund manager told us that it was now impossible to buy bearer securities in a North American brokerage account; all purchases were required to be electronic (and thus easily traceable). It would appear that the US is heading in the direction of a police state. Any evidence either supportive, or to the contrary, will be gratefully received.

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