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8th April 2011

Government agents

"Barclays' new chief executive is considering increasing the bank's risk profile, in order to hit profitability targets over the next three years.."

- Patrick Jenkins, The Financial Times, surprisingly *not* from its April 1st edition.

"The budget deficit will clearly be below forecast. The country is doing its job and doing it well. Portugal will not request financial aid for the simple reason that it's not necessary."

- Portuguese Prime Minister, Jose Socrates, 11 January.

"The "overpaid" fund management industry is destroying $1,300bn of value annually, according to an unpublished draft report conducted by IBM."

- FTfm supplement, April 4th.

Assessing the causes of the worst financial crisis since the Great Depression, widely but erroneously believed to be behind us, the common public response has been to single out bankers as the constituency most responsible for malfeasance, malinvestment and generally malodorous behaviour. But while bashing the bankers provides some form of grim relief for the increasingly beleaguered middle classes, they are merely a necessary but not sufficient target of the public's wrath, and not the sole culprits behind the crisis. It's like the dilemma of being faced with Adolf Hitler, Joseph Stalin and Peter Mandelson in a prison cell, and being given a gun with only two bullets in the chamber. (One possible resolution: shoot Peter Mandelson, twice.) Yes, we all now know that without dodgy mortgage brokers and venal lenders, foolish borrowers could not have been allowed to take out idiotic loans; that without dubious investment banks, that pyramid of idiotic loans could not have been repackaged and redistributed to idiotic investors; and that without conflicted ratings agencies, those repackaged idiotic loans could not have received the imprimatur of investment grade ratings when those same repackaged loans were technically, in the words of Richard Bitner ('Confessions of a subprime lender'), not so much chicken salad as chicken s**t.

But the chain of idiocy ignores the over-arching entity overseeing and regulating all the market practitioners listed above: **government**. Banks and financial institutions operate within one of the most heavily regulated business environments. The knee-jerk reaction to the crisis has been to call for even more regulation, more stringently applied. But if the regulator – let us call it government, for want of a narrower definition – is overwhelmed by the scale of its own mandate and the innate

venality of the industry which it oversees, more regulation merely sets us up for an even greater sequence of problems. And what government has in common with many of the market participants blithely parting investors from their capital over recent years is that, at a fundamental level, it represents the danger of agency risk as opposed to fiduciary obligation. When spending money, there are roughly three routes to market. One can spend one's money on oneself. Whether spent wisely or not, the spending is likely to be focused. The target may not be well chosen, but it is likely to be hit. Or one can spend one's money on other people. If performed voluntarily, such philanthropy is to be praised. If performed involuntarily, it is known as tax, or theft. Or one can spend other people's money on other people. Such is the role of government, and it is hardly surprising that it entails the wholesale waste and misdirection of, ultimately, trillions.

We would suggest that the role of agency risk has been under-discussed amid the broader analysis of causes of the crisis. And it is likely to perpetuate the crisis, to the extent that it is practised and concentrated by institutions that are tasked with shepherding vast sums of capital through the stormy waters ahead. Since investing other people's money comes with an inevitable dilution of concern about matters of care or hygiene, it will come as no surprise if significant portions of that capital end up at the bottom of Davy Jones' Locker. Our nomination for the best current recipient of the agency risk award: G7 government bonds. Why ? Because the government bond market is an institutional market, in which private investors play little part. It could hardly be any other way, given that the average traded size of a government bond market transaction is surely north of $5 million a time. And because the institutional players (we use the term advisedly) within that market are largely attempting to perform relative to a benchmark that is a function of market size, as opposed to quality. In other words, the institutional bond fund world legitimizes sovereign borrowers with specific reference to their level of indebtedness: the more indebted the country, the larger the capitalisation of its bond market, and therefore the more significant that country is within the bond market universe. On any rational analysis, this is an absurd state of affairs. Beyond a certain point, which even the dubiously creditworthy US may now have reached, a vastly indebted country can enjoy a formal 'AAA' credit rating, and sit proudly atop an index ranking bond market size, and yet represent a significant risk to (private) investors' capital. This sort of fundamental analysis has little appeal to institutional bond fund managers, in large part because ***it's not their own money they're playing with.*** As with other institutional participants in financial markets, they pursue a (peer group or benchmark) relative objective, as opposed to an absolute one. Even outright losses for such a fund have little meaning, provided that "the market" losses are greater.

And if there were ever a time to be concerned about the prospect of capital loss in G7 government bond markets – whether via serious price degradation consistent with rising market interest rates or, ultimately, via terminal default or inflationary repudiation – now is that time. While Portugal has been the latest sovereign to make a step forward in the direction of potential ethnic cleansing from the grand Euro project, the European Central Bank has helped it on its way by nudging Euro interest rates a tad higher, from 1% to 1.25%. That represents a rise of just 0.25% in absolute terms, but a more meaningful 25% in relative terms. For mortgage holders struggling to service their debts while interest rates rest, for the moment, at multi-century lows, the threat of higher rates in relative terms is almost tangible. The Bank of England may be next to raise rates, albeit in too pusillanimous a fashion to dent rising inflationary pressure; for the US Federal Reserve, a policy rate rise any time soon seems like a ridiculous fancy. But the timing is of secondary importance. What matters is that the interest rate cycle is turning. The tide is going out for conventional government bonds, which continue to benefit from ridiculous perceptions of risklessness. Financial markets are now transfixed by the prospect (probably an unrealistic one) of

a halt to Quantitative Easing on the part of the Fed. Playing chicken with the monetary authorities is never to be encouraged. The next few months are unlikely to be calm for financial markets.

And finally.. agency risk may be alive and well, indeed flourishing within the western government bond markets, like a particularly bouncy tumour. But as Warren Buffett and Charlie Munger have just been reminded by the actions of erstwhile colleague David "Lubrizol" Sokol, it can also be painful to have skin in the game, especially when your behaviour looks a little like insider dealing. Nobody seriously expects politicians to behave ethically. The investment stewards at Berkshire Hathaway have always been held to a higher standard. Whether we are assessing the actions of politicians or investment managers, "do as I do, and not as I say" remains the watchword during peculiarly challenging times.

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8th April 2011.

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