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14th November 2011

What we do and why we do it

"We don't get paid for activity, just for being right. As to how long we will wait, we'll wait indefinitely."

- Warren Buffett.

In treacherous markets, it helps to have some core beliefs. The statement of investment intent most meaningful to us we first came across about 12 years ago. We make no apology for repeating it here. It's contained within the late Peter Bernstein's magisterial biography of risk, 'Against the Gods' (Wiley, 1998), which more or less tops our 'required reading' list for the engaged investor. It was the first time we came across the name Daniel Bernoulli, perhaps the first behavioural economist, who essentially said the following:

For a wealthy investor, the practical utility of any gain in portfolio value inversely relates to the size of the portfolio.

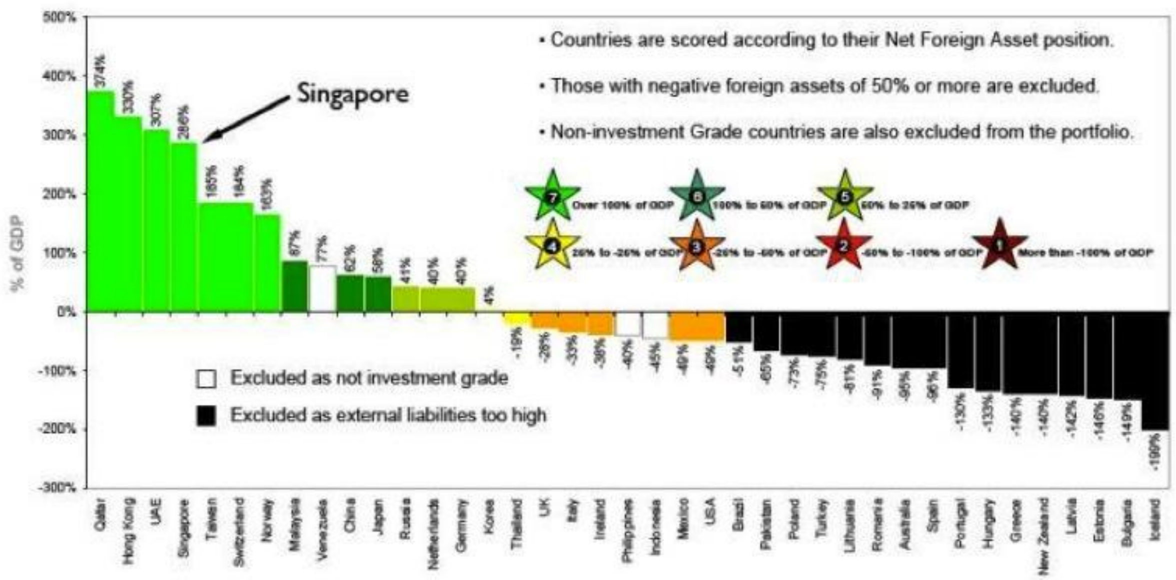
Or in plain English, if you already have a meaningful pot of capital, simply watch that pot. Bernoulli suggests, and recent award-winning behavioural financiers have proven, that most people are risk averse. We prefer gains to losses, for sure, but if we incur losses, the hurt tends to be felt twice as severely as the equivalent monetary gain. Since our clients are wealthy, our natural bias is to pursue capital preservation in real terms on their behalf. Capital preservation in nominal terms is easy, of course. We can just park our clients' cash in a sound bank – if we can find one. But at an extraordinary juncture in market history, there are heightened risks even to sound banks, and there is, we believe, more than "usual" risk of a particularly unpleasant occurrence of inflation – indeed, a serious inflationary outbreak may be the only way of "resolving" the global debt crisis.

We start with debt. It may strike some as strange to be holding any form of debt in the middle of a global debt crisis. But we cannot entrust all of our clients' funds to the dubious stewardship of the stock market – and good luck to those wealth managers who have decided to do precisely that, in the seeming absence of meaningful alternatives.

The specialist credit managers at Stratton Street raise an interesting question that is not altogether hypothetical. If you are wealthy enough to lend someone a few million dollars, to whom do you lend it ? To a rich man who has the means to pay you back, or to a poor man with a barrel-load of debts ? The question answers itself. Now consider the insanity of the institutional bond fund management world. As Stratton Street's managers point out, the whole fund management industry is built around the principle of lending to the most indebted countries or companies. In 2007, as they point out, GM and Ford had combined debts in excess of $213 billion, and were clearly in financial difficulty. At the same time, most fund management groups will have held substantial amounts of their debt. Quite why they would have held that debt is a question that they should be obliged to answer. We will attempt an answer on their behalf. Because to most fund managers, asset management has played second fiddle to asset gathering. And in a startling example of the perils of agency risk, we think it likely that most if not all of those managers would have had negligible personal investments in their own funds – they were, in other words, sublimely indifferent to the performance of their funds provided that their performance held up tolerably well against their peers. The most alarming answer is that most institutional bond fund managers invest purely on an indexed basis: for their own reasons, or perhaps due to the stupidity of consultants, they feel obligated to invest in the most heavily indebted countries because those same heavily indebted countries are the largest components of global bond indices. So when the final reckoning comes, it will not just be foolish and greedy bankers held to account. Those bankers will be joined by incompetent bond investors blithely tracking bond indices where the greatest weight is given to the biggest debtors.

Stratton Street's managers have identified an alternative method of assessing the relative and absolute attractiveness of sovereign debt. It amounts to the revolutionary concept of value. One key metric is known as "net foreign assets as a percentage of GDP", shown below:

Net foreign assets as % of GDP, selected countries



Source: Stratton Street, data as at February 2011

Net foreign assets for any country incorporate the totality of government, corporate and household assets. Why the emphasis on 'foreign' ? Take the UK and its Gilt market in government bonds. The UK will never realistically struggle to service its Sterling-denominated debts because in extremis it can always print more currency. (It cannot guarantee to maintain the purchasing power of that currency, but we don't want to give away the potential ending to this crisis.) But the UK has also borrowed in US dollars, for example. Since the UK cannot print dollars (not legally, at any rate), it is critical that we consider foreign as well as domestic assets to try and assess the quality of our sovereign balance sheet. Hence net foreign assets as a percentage of GDP.

The chart above shows various countries identified and ranked by this metric. The bright green (good) countries – Qatar, Hong Kong, UAE, Singapore.. – have a pleasing surplus of foreign assets. The middle ground, including the UK and the US, have deficits, though not necessarily terminal ones. The lunatic fringe, shown in black at the far right of the chart – including Greece, Portugal, Spain.. – have no net foreign assets, only liabilities. So here's a revolutionary thought: lend your money to countries, or to entities within those countries, that actually have the resources to pay you back. Do not lend to countries that are insolvent basket cases. No, no need to thank us or Stratton Street for this extraordinary insight into the fundamentals of debt investing. Another interesting characteristic of this approach ? The fund which puts theory into practice, namely the New Capital Wealthy Nations Bond Fund, has diversified bond investments in what are objectively amongst the most creditworthy countries in the world. But whereas "riskless" government bond markets like those of the UK and the US have 10 year paper yielding barely more than 2%, the Wealthy Nations Bond Fund currently yields approximately 8%. Interesting, n'est-ce pas ?

Pursuing the Bernoulli principle of capital preservation, we feel obligated to diversify by asset type. The chart below shows the dismal history of the UK stock market over the last decade or so.

FTSE 100 Index, last 12 years

Source: Bloomberg

The market hasn't just gone nowhere since topping out in December 1999, it's fallen by roughly 20%. So much for "stocks for the long run". Bank those returns, Jeremy Siegel ! (Of course, if we really wanted to put the equity cat among the pigeons, we'd be reprinting a chart of the Nikkei, but there's only so much misery the human spirit can bear.) So UK equity market investors have essentially been sitting in a leaky boat taking on water for the past decade.

But that's just the index. Just as we're not obliged to track bond indices for a living, nor are we beholden to trudging the unpredictable course of the equity market. The one benchmark we do feel professionally obligated to try and beat is cash – the only asset class that cannot decline in nominal terms. Of course, given the existing and potential inflationary pressures, we have to take some consideration of the erosion of our clients' purchasing power being pursued so magnificently by Mervyn King and his friends throughout the world.

So we do hold equities, but we prefer to own the shares of businesses that will still be around in a few years' time. The finest single metric of the several that we use in this cause is the Altman Z Score, defined below by Bloomberg:

The Altman Z Score indicates the probability of a company entering bankruptcy within the next two years. The higher the value, the lower the probability of bankruptcy. A score above 3 indicates bankruptcy is unlikely; a score below 1.8 indicates that bankruptcy is possible.

It is calculated as follows:

Z = 1.2 x (Working Capital / Tangible Assets)

+ 1.4 x (Retained Earnings / Tangible Assets)

+ 3.3 x (Earnings Before Interest and Taxes / Tangible Assets)

+ 0.6 x (Market Value of Equity / Total Liabilities)

+ (Sales / Tangible Assets).

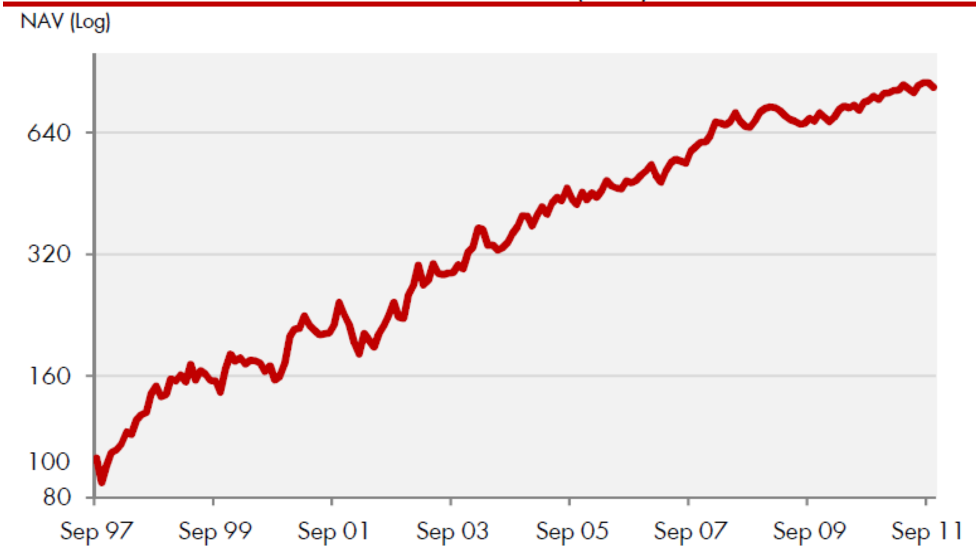
The Altman Z Score cannot be calculated for financial companies, but that's no great loss since we don't want to own them anyway.

We don't use Altman in isolation. We also want to favour certain sectors over others (the broadly defensive nature of pharmaceutical, utilities and tobacco stocks, for example), and we also want relatively high dividend yields, and good dividend cover, and little or no debt – but the Altman Z Score is a pretty good place to start.

And the diversification continues. While we are perfectly content to hold quality stocks at fair prices, we cannot discount the possibility that undisciplined sheeple and / or trading robots will stampede in and out of the markets in a disorderly way. The possibility (probability) of a major European banking crisis does not exactly diminish this risk, so we also like holding instruments that offer little or no correlation to the stock market. One of our favourite types is the systematic trend-following fund. A good example of such funds is Winton Futures.

The performance of the Winton Futures Fund since inception is shown below:

NET PERFORMANCE SINCE INCEPTION (USD)****



Source: Winton Capital Management ltd (based on monthly data)

Its compound annualised average returns are approximately 16.2%; approximate year-to-date returns stand at 3.5%. Another reason we favour systematic trend-following funds is their historic lack of correlation to traditional assets, notably stocks. From inception, the correlation of Winton Futures to the MSCI World Equity Index has been 0.00.

Our final asset choice, and our current favourite, given our assessment of the macro outlook, is real assets. Within the real assets space, as regular readers and our clients will not be surprised to learn, our preferred asset is gold. The log chart for gold since 2000 is shown below. What a star.

Gold price in US dollars, last 12 years, log chart

Source: Bloomberg

Put all these various asset classes together, and you have a pie chart that looks something like this:

Current Asset Allocation, CLI Spa Core Portfolio

Source: PFP Wealth Management LLP

The CLI Spa Core portfolio is an offshore investment fund we manage under the administration of Canada Life International (CLI) in the Isle of Man. While the offshore bond wrapper offers certain tax advantages, the fund is essentially designed to replicate what we do within our core discretionary portfolios. This fund was launched in August 2008 just in time for the collapse of Lehman Brothers. Although its asset allocation has evolved over the last three years, it has always maintained exposure to each of our four thematic allocations described above. Its performance is shown below (in blue), versus that of its sector (in red):

CLI Spa Core Portfolio versus the Offshore Insurance Mixed Asset – Flexible sector

Discrete Performance (%)	2010	2009	2008	2007	2006
CLI Spa Core Portfolio	18.36	8.21	-	-	-
Sector (Offshore Insurance Mixed Asset – Flexible)	8.40	18.86	-30.89	-4.25	6.87

Source for data: Financial Express TrustNet Offshore

Since we started with Buffett, we might as well finish with him:

“The first rule is not to lose. The second rule is not to forget the first rule.”

This may appear utterly obvious, but there is evidently no shortage of active managers and hedge fund managers that either never heard it or have chosen to forget it. This is not, of course, an easy investment market. But having established a process that we believe is sensible, rational, intellectually defensible and successful, we are hardly going to abandon it in favour of anything else.

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14th November 2011.

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