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Problem-solving

"FTSE 100 could hit 7,000 if the Bank of England prints more money"

- Telegraph headline implicating Legal & General's Ben Gill as the inflationist paper-bug.

Any Martian watching events down here would be scratching its head more than usual. The ONS reported that UK GDP contracted by a worse than expected 0.3% in the last quarter of 2011. Construction industry output fell by 0.2%; manufacturing output by 0.7%. And the OECD indicated that the UK was back in recession (no big surprise to us since we never believed we came out of the last one). So what was occupying the twittering classes more than anything else last week ? The tax rate on pasties. This supposedly punitive tariff has been seized upon by left-wingers as dark evidence of a Conservative plot against the lower orders; as political blogger Guido Fawkes pointed out:

"We now live in a country where caviar is untaxed and a hot pasty is.. Go figure."

Or perhaps the furore over the tax rate on cheap pastries simply reflects the underlying absurdity of the ongoing annual irrelevance that is Britain's Budget – an endless cycle of tinkering at the fiscal margin that ultimately benefits nobody other than a narrow clique of lawyers and accountants.

Notwithstanding the above, this week's letter may yet end up being positive. If it does, it will be in no small measure thanks to David Deutsch, whose recent book 'The beginning of Infinity: explanations that transform the world' seems little short of a masterpiece. Deutsch is a computational physicist. For the layman, this means that, unlike an economist, he actually has a clue what he's talking about. And what he's talking about boils down to a fundamental optimism about the nature of humanity, as the two stone carvings below might tend to suggest:

Source: David Deutsch, 'The Beginning of Infinity' (Allen Lane 2011)

In his words,

"It is inevitable that we face problems, but no particular problem is inevitable. We survive, and thrive, by solving each problem as it comes up. And, since the human ability to transform nature is limited only by the laws of physics, none of the endless stream of problems will ever constitute an impassable barrier. So a complementary and equally important truth about people and the physical world is that ***problems are soluble***. By 'soluble' I mean that the right knowledge would solve them. It is not, of course, that we can possess knowledge just by wishing for it; but it is in principle accessible to us."

Admittedly, Deutsch is referring to problems that can be observed, studied and resolved scientifically. But just because the scale of his landscape is cosmic and ours inhabits the more narrowly quotidian range of the investible does not invalidate the application of his method to the more behavioural problems of the financial. If human brainpower can split the atom, it can surely devise a prudent way of navigating through the investment excesses of these dismal times.

To solve a problem, you first have to identify it correctly. Know your enemy. Here, in no particular order, are our suggested big problems afflicting the investor's world of today:

1. Too much debt

2. Insufficient economic growth to service that debt

3. Too many functionally insolvent banks

4. Too many off-balance sheet claims against finite government (taxpayer) resources

5. Central banks have utterly exhausted their armoury of the conventional and are now making it up as they go along

6. Uncontrolled and possibly uncontrollable monetary stimulus, in a general environment of fundamentally unsound money

7. Widespread currency debauchery

8. Vast manipulation of all major asset classes courtesy of Problems 1-7

9. No objectively and unimpeachably safe havens

10. Politicians.

In the spirit of William of Ockham, the simplest investment response can be assumed to be the best. Nature may abhor a vacuum, but in the world of investments, there are no automatic penalties for non-participation in ugly markets. So if we take violent exception to a given asset or asset class, the simplest response is surely just to avoid it. (Note: institutional managers, especially product specialists and closet or explicit index-trackers, may not be able to operate to similar rules.) So at the risk of vast over-simplification, here are our responses:

1. *Problem: Too much debt*
   Solution: **Avoid crappy bond markets**.

2. *Problem: Insufficient economic growth to service that debt*
   Solution: Not actually our problem – we are investors, not policy-makers.

3. *Problem: Too many functionally insolvent banks*
   Solution: Ditto. But **avoid crappy banks** (that is to say, most of them – either as potential cash custodians or, just as importantly, as equity or bond investments).

4. *Problem: Too many off-balance sheet claims against finite government (taxpayer) resources*
   Solution: See 1.

5. *Problem: Central banks have utterly exhausted their armoury of the conventional and are now making it up as they go along*
   Solution: See 2.

6. *Problem: Uncontrolled and possibly uncontrollable monetary stimulus, in a general environment of fundamentally unsound money*
   Solution: Spend more time focusing on investments incorporating fundamental quality, creditworthiness, lack of counterparty risk and scarcity. E.g. **precious metals in physical form**.

7. *Problem: Widespread currency debauchery*
   Solution: See 6. If paper currencies are sought, vote explicitly for those of sovereign players which have objectively sound economies, banking systems and balance sheets. E.g. **Singapore**, which as Stratton Street Capital point out "is at the heart of the economy in Asia in many ways. Despite its small size it is a centre of trade, a financial centre, and a wealthy nation with an appreciating currency; the Switzerland of Asia. [And with a sound currency to boot. – Ed.] The recently released manufacturing figures give a picture of a country still succeeding in its goal of innovating in high value added industries. Overall manufacturing was "only" up 12.1% year-on-year to February, slightly lower than some expectations, but biomedical manufacturing (pharmaceuticals and medical devices) rose 38.3%, and marine and offshore engineering was up 41.7%, largely on the basis of oil-related technology.. Total trade rose by 26% year-on-year."

8. *Problem: Vast manipulation of all major asset classes courtesy of Problems 1-7*
   Solution: In this environment, investments are only to be owned, not rented[1]. Lombard Odier's CIO Paul Marson cites a coinage from the earlier, more successful version of Warren Buffett: "**Only buy something that you'd be perfectly happy to hold if the market shut down for ten years**." Perhaps the most heavily manipulated market is that in crappy government debt, courtesy of the uneasy fusion of insolvent governments with insolvent banks, and helped on its way to untenably low yields by an institutionalised and largely price-insensitive agency player marketplace focused on benchmarks. Private clients need not participate in this market, except to laugh at the other players. But spillover from monetary stimulus is undoubtedly triggering waves in equity markets. To avoid sinking, focus on valuation, not momentum.

   [1]If renting turns out to be unprofitable, investments will end up being owned anyway.

9. *Problem: No objectively and unimpeachably safe havens*
   Solution: Notwithstanding the lack of "true" safe havens, **bullion** probably comes as close as we can get in this fallen world. But see also sensibly priced businesses with a genuine commercial edge and principled, as opposed to Wall Street-style, leadership.

10. Problem: Politicians.

Solution: **Elections**. Not the finest answer, perhaps, but the only printable one we have.

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