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Flight animals

"Since the disastrous failure of Icelandic bank Landsbanki in 2008, UK savers have been more nervous about holding money with overseas banks.

"However, UK savers have ploughed money into Bank of Cyprus to take advantage of its high interest rates."

- From 'Bank of Cyprus seeks UK deposit protection,' The Financial Times, 7 June 2012.

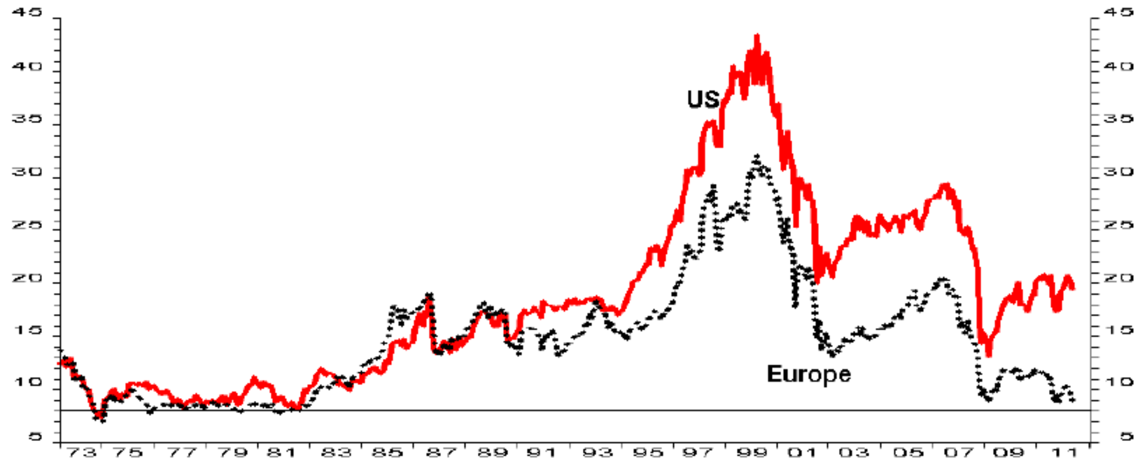
We were talking to prospective clients a week or so ago, and one of them during the course of conversation cited the example of a shire horse that had got spooked whilst out on the road. It had probably only been a shadow, but it had evidently been enough to cause the horse to rear up and threaten to bolt. We expressed surprise that an animal as tall as one-and-a-half people, weighing at least 1,000 kg, and capable of pulling a load of perhaps 10 tons should be frightened of anything, let alone a shadow. "But they're flight animals," he replied.

And so, in many respects, are we. Many investors, faced with the growing likelihood of some sort of financial earthquake epicentred in the Eurozone, will be minded to panic first and ask questions later. But such a flight response tends to conflate what we call 'volatility' with what we term 'risk'. They are not exactly the same thing. More specifically, 'volatility' is an inevitable by-product of investing in public or exchange-traded or listed instruments or anything that can be purchased or sold in a financial market. As JP Morgan (the man, not the bank) once said: markets fluctuate.

And then there is risk. The risk that most concerns us is the possibility, however remote-seeming, of a permanent loss of capital. As JP Morgan (the bank, not the man) would no doubt attest, spuriously scientific measures of risk such as Value-At-Risk, which the bank helped to develop, only get you so far.

In seeking to limit exposure to the apparent slow motion train wreck that is the Eurozone, we have consciously avoided some of the more obvious red flags: the Euro itself, for example, or Eurozone stocks, Eurozone sovereign bonds, and certainly Eurozone financials. Some of these risks may well turn out to be dazzling opportunities: in our last commentary, 'Mayday', we cited SocGen's Albert Edwards and Dylan Grice, who point out that on a cyclically smoothed basis, US equity markets are a long way from being cheap; but in the same research, they highlight that European stocks, on the other hand, are already cheap, and may be disgustingly so. European cyclically adjusted p/e ratios are now back to where they were in 1982.

European cyclically adjusted PE back to rock bottom



Source: Datastream

As Edwards and Grice suggest,

“Investors are reluctant to invest amid all the ongoing chaos in the Eurozone. But the macro backdrop ALWAYS looks awful when the market is this cheap.”

That said, there is a danger in the naïve presumption that if and when Eurozone politicians or the ECB ever manage to get their house in order, then our investment problems will be over. They will not. (There is also a danger in the naïve presumption that Eurozone politicians or the ECB are even capable of getting their house in order.) The developed world, the US and Japan included, are drowning under a sea of probably unpayable debts, so the Eurozone crisis is not even geographically specific. Any attempt at resolving the (almost uniquely politically constrained) Eurozone debt crisis will likely result in the same sort of explicit state-sanctioned inflationism that is making the likes of US Treasuries and UK Gilts look like taking one last wild drag on a giant cigar in the middle of a cavern coated with kerosene.

Sanlam fund manager Kokkie Kooyman writes that he and his colleagues are getting two types of phone calls at present:

- Large, sophisticated investors are calling and saying, “I hope you’re fully invested.” They have made their asset allocation call and want to make sure that when the bounce comes, we are 100% invested.

- Smaller investors more prone to panic are calling and want to know, “What is the likely outcome in Spain and how will it affect the market ? Should I withdraw my investment ?”

What makes this observation more poignant is that his home market is South Africa, as opposed (say) to the Eurozone itself. We would like to tell our clients that their investments are safe. Unfortunately today there is no such thing as safety in investment markets. Perhaps there never really was, only relative degrees of perceived safety as yet unassailed by political contrivance, pandering to banking interests, desperate inflationism, and appropriation gone off the scale. Central bank action has conclusively eroded the objective safety of all formerly “riskless” assets in their generalised war against savers. That said, we believe there are still varying degrees of safety and risk (objective as well as subjective), and the market for each is not even remotely efficient. We are more than content to hold objectively creditworthy investment grade sovereign debt yielding more than 6%, when supposedly riskless sovereign debt issued by the US, UK or German governments yields less than inflation and in some cases provides no yield whatsoever (and indeed in some cases offers a negative yield in nominal terms as well as real). We are content to have relatively modest exposure to what we believe are broadly defensive stocks (listed outside the Eurozone) offering satisfactory and well covered dividend yields way higher than those offered by peer government debt. Such investments are not without a degree of attendant price volatility but as we have already suggested, volatility and risk (especially the risk of permanent loss of capital) are hardly the same thing. We are happy to maintain exposure to funds managed to an explicitly market-uncorrelated objective. And we are especially happy to hold capital in the form of the monetary metals, gold and silver, during a period when the ongoing debauchery of paper money looks assured. The distinction between volatility and risk can be well viewed in the recent performance of gold. Its price has recently been volatile as expressed in nominal dollars (themselves a currency not backed by anything tangible or finite). But "risky" ? Does gold represent the threat of permanent loss of capital ? Does it represent any form of counterparty risk whatever ? Could it ultimately deteriorate towards an intrinsic value of zero ? The US Dollar ultimately could, because throughout history every paper currency always has. The mighty Dollar will not be immune to this iron trend – it will merely be a survivor by comparison to the weaker currencies that will fall before it.

Man is not a flight animal, although plenty of investors are. While we have fled pre-emptively from certain types of asset (the Eurozone being a good catch-all description for the time being), we have also elected to stand and fight in others. In some respects, "fight" in these terms could be construed as closing one's eyes to an encroaching tide and simply choosing to ignore a grave market threat. But if the answer is "flight" from risk altogether, then the question has to be "where to ?" Cash is not a satisfactory answer, merely a guarantee of further erosion of purchasing power (and hefty dollops of counterparty risk and moral hazard). Conventional bonds are not a satisfactory answer – see the current yields of US Treasuries, UK Gilts or German Bunds for a more developed explanation. So there are no easy answers, and no easy bolt-holes. But we do happen to like the ones we've found. Until we discover some better ones, we're quite content to ride out the storm from within our diversified asset fastness.

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