PFP Wealth Management

3 Windsor Court
Clarence Drive
Harrogate, HG1 2PE
01423 523311

Lion House
72-75 Red Lion Street
London, WC1R 4NA
020 7400 1860

www.pfpg.co.uk

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Great Expectations

"**Brazil bank strike**

Central bank staff are striking for a 23% pay deal to keep pace with inflation, even though one of the institution's key roles is to curb inflation."

- FT News Briefing.

The Chinese apparently have a saying: a man who cannot smile should not open a shop. The same logic doubtless holds in asset management, too. Expressing a downbeat or even wary opinion about financial markets or the economic environment hardly acts like a tractor beam for clients, even and especially when caution might be preferred to gung-ho all-in investment. But investors should be careful what they wish for. Optimism and confidence may be contagious, but they may also be outright dangerous in the context of a global financial crisis that still shows no signs of resolution. And it is not in the commercial interests of professional fund managers to deliberately shrink their assets, so credit, for example, to hedge fund manager Louis Bacon who has announced plans to give back $2 billion to his investors, citing constrained liquidity and opportunities and a "risk on / risk off environment [that] appears to be an abiding presence".

The reality is that most asset managers are mere economic agents who have little or no skin in the game. As Jeremy Grantham has said well, the primary objective for any asset manager is to keep his job. Those focused on specific sectors have no incentive to talk down prospects for those sectors because for the vast majority of professional investors, more assets under management equals more pay, as simple as that, and fiduciary obligations can go hang. So another mention in despatches is due to Pimco's Bill Gross, who recently wrote as follows:

"Unfair though it may be, an investor should continue to expect an attempted inflationary solution in almost all developed economies over the next few years and even decades."

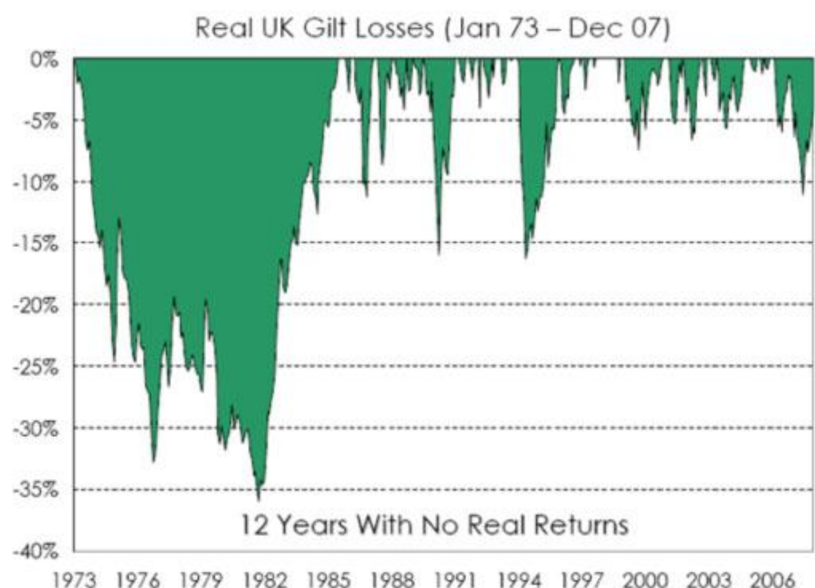
Admittedly, "an attempted inflationary solution" is not exactly the same as stating that we are destined to endure inflation, but the thought is father to the deed. And unless we see a violent transition in the monetary order, for the foreseeable future it is going to be a war between central banks and the rest of us. (Note the reference to abject Brazilian central bank policy failure above.)
For the manager of the world's largest bond fund to suggest that "the cult of inflation may only have just begun" is pretty bold stuff, in our view. Writes Mr Gross:

"**The primary magic potion that policymakers have always applied in such a predicament is to inflate their way out of the corner. The easiest way to produce 7–8% yields for bonds over the next 30 years is to inflate them as quickly as possible to 7–8%!** Woe to the holder of long-term bonds in the process! Similarly for stocks because they fare poorly as well in inflationary periods. Yet if profits can be reflated to 5–10% annual growth rates, if the U.S. economy can grow nominally at 6–7% as it did in the 70s and 80s, then America's and indeed the global economy's liabilities can be "reflated" away. The problem with all of that of course is that inflation doesn't create real wealth and it doesn't fairly distribute its pain and benefits to labour/government/or corporate interests. **Unfair though it may be, an investor should continue to expect an attempted inflationary solution in almost all developed economies over the next few years and even decades.** Financial repression, QEs of all sorts and sizes, and even negative nominal interest rates now experienced in Switzerland and five other Euroland countries may dominate the timescape."

We have been suggesting for some time that prospects for UK Gilts (and US Treasuries) are at best dire. The ultimate fate of Gilt and US Treasury holders for us is somewhat academic, in that we're not among them, nor would we be reckless enough to short any market prone to such outrageous manipulation by the monetary authorities. But an objective concern for Gilt investors is not a trivial matter when so many pension funds are being coerced / financially repressed into holding them. Now is the time for pension trustees to stand up for the interests of their pensioners rather than caving in to the robotic guidance of consultants and the regulators.

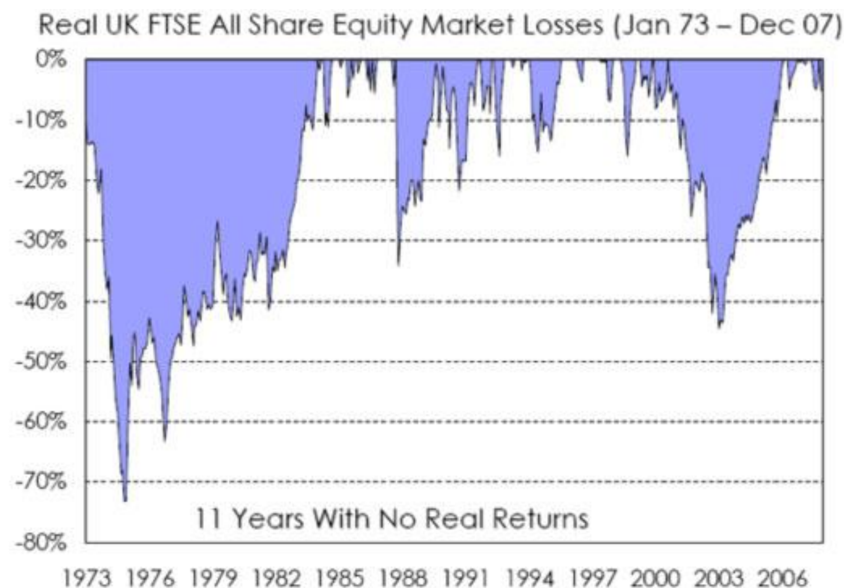
A presumption that has slowly crept into the mainstream of financial thinking has it that if the likes of Gilts and US Treasuries (and German Bunds, etc. etc.) are a waste of time for longer term investors (as they surely are now), then common stocks must be the answer. This probably owes something to a lazy and somewhat hazy belief that stock and bond prices must always and at all times be negatively correlated. But as Bill Gross points out, ***stocks can also fare poorly in inflationary periods***. Or to put it another way, suppose they threw a bear market for stocks ***and*** bonds, and attendance was compulsory ?

This has happened before. In the inflationary / stagflationary 1970s, both stocks and bonds were clobbered. Gilt returns were bad: it took 12 years for an investor in Gilts in 1973 to claw his way back to break-even in real terms:



Source: Frontier Capital Management

But equity market returns were worse. Not only did it take 11 years for an investor in UK equities in 1973 to be made whole again, but he incurred mark-to-market losses of over 70% in the process. No doubt many investors elected not to hold on for the long term but bailed out at a loss.



Source: Frontier Capital Management

We say all this and cite what we feel are appropriate sources not to try and scare the horses, but simply to point out that investor expectations – in the middle of a global financial crisis that last week was widely commemorated for its fifth anniversary – are in danger, either through boredom at crisis fatigue or unwarranted optimism, of getting out of hand. The market doesn't owe us a living any more than the world does. Our response to the crisis has been consistent throughout the last five years. We summarise our core beliefs below:

1. Portfolio management (at least for our clients) should not be about maximising investor returns under all market environments, but rather about minimising the risk of catastrophic loss.

2. Traditional benchmarks (notably equity and bond benchmarks) are completely irrelevant for most investors. We believe strongly that equity (or bond) indexation is a product-based and not a needs-based solution.

3. There is always an alternative to an unwarranted reliance on either bonds or equities.

4. Alternative investments are not inherently risky.

In one of our favourite quotations in finance, Daniel Bernoulli (1700-1782) suggested that

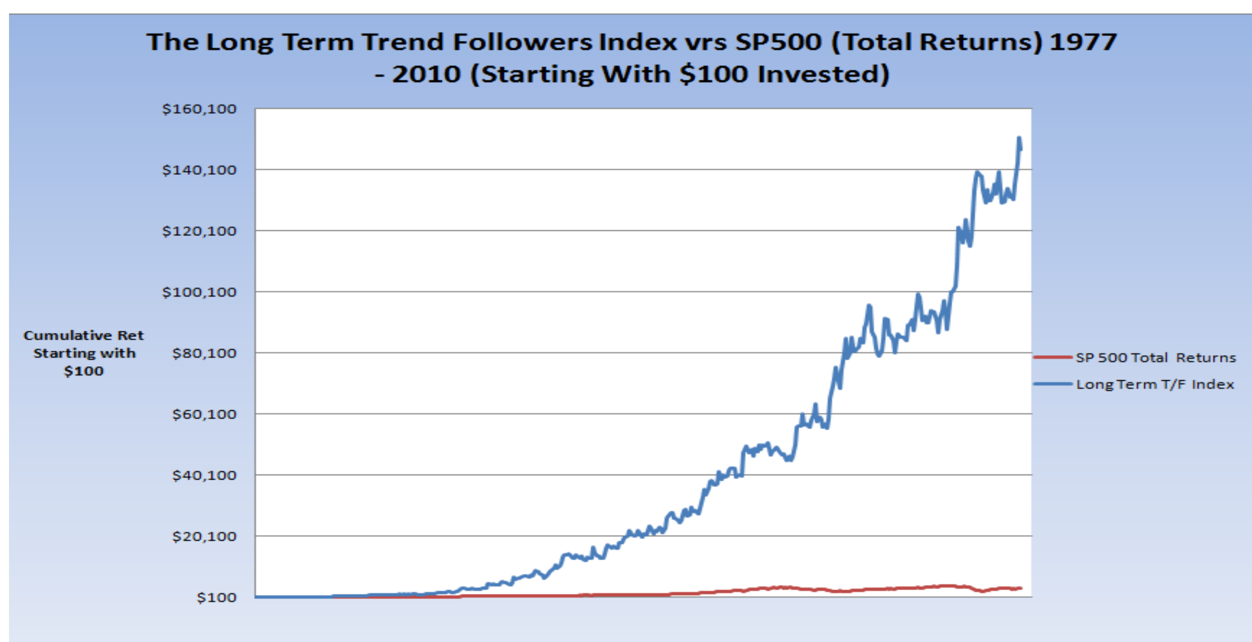
"The utility resulting from any small increase in wealth will be inversely proportionate to the quantity of goods previously possessed."

We think that this is probably one of the first pronouncements in the history of behavioural finance. Bernoulli's key insight was that wealthy investors need not 'go that extra mile' in search of supernormal returns since they have wealth to begin with. More recent scientific studies appear to have confirmed a general psychological bias in favour of profits versus losses. Of course we prefer

profits to loss, but the intensity of the psychological response is not an equitable one. Faced with a specific dollar or percentage gain (or loss), the loss hurts much more than the gain gives pleasure. Our response to gains and losses is asymmetrical: losses matter more. So in the interests of the investor's psychological well-being alone, quite apart from any rational investment process that might be warranted given the macro environment, the risks associated with striving for higher than market returns, or even matching market returns, are probably not worth taking.

This is not to say that we don't invest in stocks or bonds, far from it. But we draw a distinction between speculation and investment. We're happy to invest in common stocks provided a) valuations seem reasonable from the perspective of an already conservative investor, b) sector and stock-specific characteristics are either broadly defensive or offer unusual prospects for meaningful long term growth and c) the stock offers an attractive dividend yield that is itself well covered. And we are happy to invest in bonds under similar constraints, namely that the issuer is unusually creditworthy and the yield alone justifies the investment. We would note in passing, for example, that UK Gilts (per the FTSE Actuaries Gilt Index) this year have returned, as at end July, 4% all-in, and that yields in that market are now eye-wateringly slim. Our favourite bond fund, the New Capital Wealthy Nations Bond Fund, which we regard as an altogether superior credit risk, has in GBP for the same period returned 13%. You pays your money..

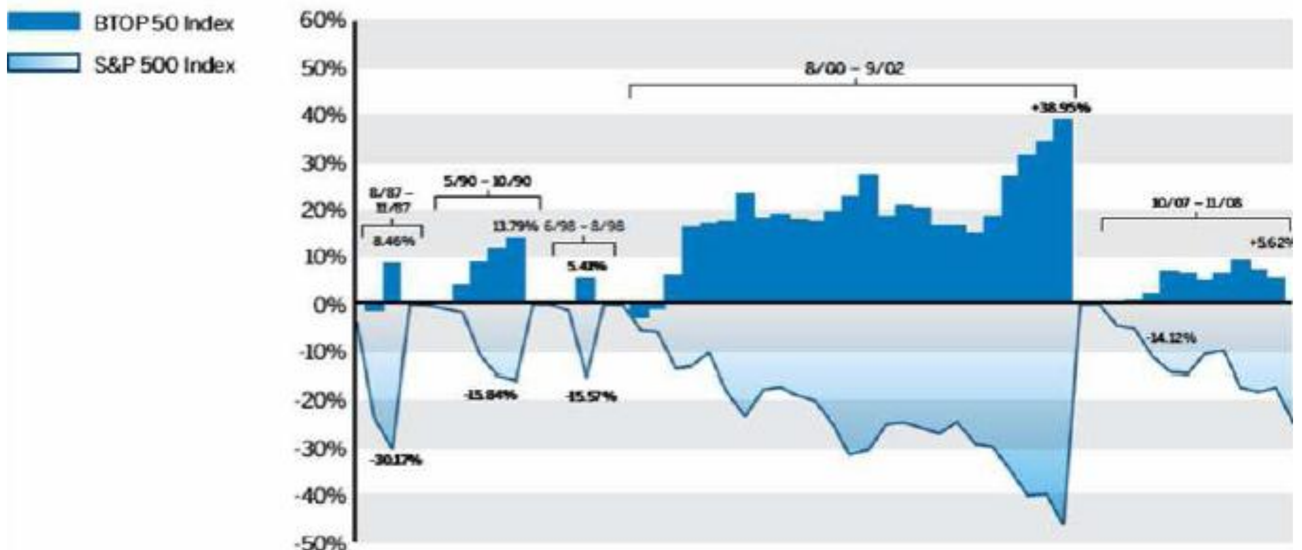
In terms of "alternative" investments, we place significant faith in two types. One we term uncorrelated investments, specifically systematic trend-following funds. We use trend-following managers for a number of reasons, not least because it's the one sector in active asset management that doesn't attempt to anticipate or ***predict*** future market direction but simply ***responds*** to historic trends in prices and looks to exploit strongly trending markets as and when they arise. More simply, we expect that markets will continue to oscillate between cycles of greed and fear, and trend-followers strike us as a plausible and almost entirely objective and non-emotional way of benefiting from those trends. There are two other non-trivial reasons for their adoption: their long term returns have been impressive, and their historic correlation to equity markets, for example, is close to or at zero. The following two charts display each of these characteristics.



Source: Lawrence Clarke Investment Management

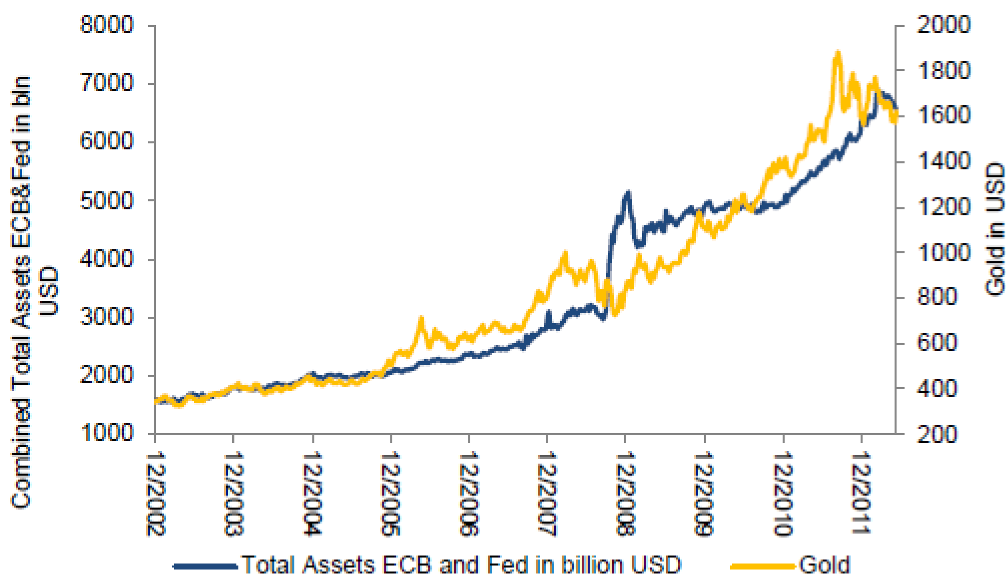
The first chart, above, shows the performance of long term trend following funds versus the S&P 500 (total returns basis) between 1977 and 2010. Notice that the S&P 500 – during the biggest equity bull market in history – looks more or less like a flat line by comparison.

The second chart, below, shows the performance of an index of trend-following funds versus the S&P 500 during the latter's worst drawdowns since 1987. Note that trend-following funds effectively act as a more or less perfect hedge against severe bear markets, generating positive returns when the equity market incurs significant periods of loss.



Source: BarclayHedge

Last, and by no means least, we allocate capital to real assets, notably to the monetary precious metals, gold and silver. Why ? Once again, a picture says a thousand words.



The chart, courtesy of Ronald-Peter Stoeferle of Erste Group, shows quite clearly that, far from being in some sort of unsustainable bubble, gold is simply patiently tracking the rate at which the likes of the ECB and the US Federal Reserve are inflating their balance sheets. Gold, as one would naturally have predicted, is acting to protect the real value of investors' capital in a world where fiat currency is being painfully devalued by central banks solely concerned with "maintaining" the "stability" of the banking system (and increasingly, monetising government debt). And we're with Bill Gross: explicit inflationism seems like the inevitable end-game for grotesequely indebted governments and their increasingly desperate monetary authorities.

Five years into the crisis, the way out seems as distant as ever. (Now imagine a kindly shopkeeper with a benign, smiling face..) This need not be a disaster, provided one makes use of i) greater than usual asset diversification and ii) an explicit focus on value and iii) that one treats government and officialdom in all its forms with more than the usual degree of scepticism if not outright contempt. We suspect now that the most vulnerable investors in the years ahead will be those that are either hopeful, credulous or both.

Tim Price
Director of Investment
PFP Wealth Management
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Email: tim.price@pfpg.co.uk Twitter: timfprice

Weblog: http://thepriceofeverything.typepad.com Group homepage: http://www.pfpg.co.uk

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