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The Terminator

"Our Russian psychosis has two curious features. Firstly, that an 80 per cent Christian Orthodox society for some reason reacts to a Mayan calendar which no one has ever seen. And secondly, that the end of the world is perceived as an economic crisis that can be survived on the banal level of consumption."

- Russian broadsheet 'Vedomosti', quoted in The Daily Telegraph last Friday in an article entitled 'Russian residents buy up tinned goods and matches ahead of apocalypse'.

Speaking of apocalypse, there is an increasingly urgent debate occurring in what's left of the financial markets over the stability of that mountain of government debt that sets its long shadow over everything. The mountain is not localised or restricted to any one region. As befits the current economic climate, it's global in scale and intractable in structure. As Kyle Reese remarks of The Terminator in the film of the same name, the debt mountain

"..is out there. It can't be bargained with. It can't be reasoned with. It doesn't feel pity, or remorse, or fear. And it absolutely will not stop, ever.."

A bond fund manager makes the following comment on David Fuller and Eoin Treacy's excellent Fullermoney strategy website:

"If this is a bond bubble it is the most widely anticipated 'bubble' I have ever seen; everyone is identifying it. A second point is that the debt de-leveraging process and time frame is not like emerging from a less leveraged recession. It is a pernicious and deflationary phenomenon. Witness that for all the stimulus the CBs [central banks] are throwing at the issue, it has been terribly hard to create growth, inflation or cause rates to rise. We are getting minimal aggregate GDP growth in the developed world even with historically unprecedented base money creation.

"In addition, governments will be doing all they can to contain if not reduce costs and can be expected to shrink over the next 20 years as a percent of GDP. So no stimulus is coming from leveraging as we have had for the past 30 years and no stimulus is coming from government growth. Periods such as this can take 10-20 years to relieve debt levels through default, repayment, inflation and growth, even without deteriorating demographics.

"In the meantime, the leveraged part of economies (govt, banks, housing (?)) hobbles along. And there is limited upward pressure on wages and input prices upon which inflation gauges are based. So I would just posit an alternate scenario. High yield corporate bonds should offer a powerful

coupon and repayment prospects that might just be one of the best margins of safety in a continuing hobble-along environment (even though 2013 will be stronger). And the consensus waiting for the bubble could be like waiting for Godot. Just an alternate scenario to be considered. One other brief point: shorting debt is painful - you buy a bond and you receive a coupon, you short sell a bond and you pay the coupon away. So you have to get your timing right or shorts are an expensive position to carry. So keep duration short, buy the dips and enjoy the carry. And if you choose to short, buy equity puts rather than shorting rates, it's cheaper."

David responded as follows:

"**I will repeat what may be the most important of your many interesting points:**

"*Periods such as this can take 10-20 years to relieve debt levels through default, repayment, inflation and growth, even without deteriorating demographics.*"

"My premise is that if there is any bubble in today's global markets, it is most likely to be bonds, given their 30-year plus bull market which is still being extended by QE. There are many other disquieting signs, including the surging issuance of fixed interest investments, investors' ravenous appetite for them, and the often negligible yields that we now see. Surely these are bubble characteristics.

"All big, long-term bull markets are rational and justified for much of their duration, but they eventually become manias and therefore bubbles, which are a lot easier to see with hindsight. However, they all include some of the points mentioned in the paragraph immediately above.

"The challenge of bubbles is that they are often the most rewarding opportunity, up until the time they eventually burst. We have all seen this before. Seductively, bubbles therefore appear reassuringly safe and rational, while they are still inflating. Investors inflating the bubble become overconfident.

"The US and other similar bond market bull trends clearly have yet to burst. If the markets you are dealing in are destined to follow Japan's script, then the participants will continue to profit for an indefinite period. However, if / when the US and some other countries with similarly record low yields emerge from their economic sloughs in the next few years, as I suspect, their bond bubbles will burst.

"Remember, the warnings of bubbles always come 'too soon'. For the many who are participating in these low yielding fixed interest markets, good luck and more importantly, use trailing stops and / or exit quickly when the trend falters, and do not be tempted back in by the first sharp setback. Probably the most important signal, other than clearly adverse price action, would be the end of QE and rising short-term interest rates."

We apologise for quoting so extensively from the website, but this is important stuff – perhaps the most important debate currently raging in the investment markets.

Our take is as follows. David Fuller's correspondent above has, in his own words, "been managing fixed income for 25 years." He writes "just to keep group-think in check". The most dangerous advice that this writer considers he ever received was as a bond salesman at Merrill Lynch in the late 1990s (a place that dispensed plenty of dangerous advice in its own right): to thrive, one

should specialise. We didn't buy that advice then, and we don't buy it now. We have every respect for David Fuller's correspondent, but the problem with focusing on just one asset class throughout a career in finance is that it dominates one's vision and thought to the exclusion of all else. Rather than being an expert specialist, we would much rather try and be a competent generalist.

Any competent generalist, we think, would share David Fuller's view that bonds look dangerously like being in something of a bubble. The problem with the City, with Wall Street and with the asset management world is that they tend to be populated by specialists (expert or otherwise). And as Warren Buffett has pointed out, you don't go to a barber asking whether or not you need a haircut. So we should not be surprised when a bond specialist sees no particular evidence of a bubble in the one asset class that remunerates them.

Investing is a probabilistic endeavour. There are no certainties to speak of. We can only operate on the basis of rational analysis and prudent, considered risk. That, in turn, presumes that free financial markets are being allowed to operate. But they are not (not in the case of government debt markets, at any rate). Cash-strapped, heavily indebted western governments are rigging the bond markets for their own ends. They are keeping borrowing costs artificially low by coercing their most biddable opponents in the notionally private sector (banks and pension schemes) to hold government debt through the offices of financial repression. Their agents, in the form of central banks under their direct or indirect control, are wilfully cooperating in this scam. If private sector companies operated in this way in the management of their own debt, their chief executives would end up in a prison cell.

So one cannot really "trust" price and yield signals from the government bond markets of the world (notably those of the egregiously indebted western economies).

This letter is arguing, in effect, that there are insufficient generalists operating in the capital markets. An unconstrained generalist investor would not merely cling on to the bull story in debt to the exclusion of all other forms of investment. He or she might also consider the world of equities. He or she might also consider uncorrelated trading strategies. He or she might also consider the use of real, tangible, non-financial assets. We do. We consider, and actively allocate, to all of them.

In his farewell letter to clients of his erstwhile employer, the French bank SocGen, analyst Dylan Grice wrote a paean of praise to the humble cockroach.

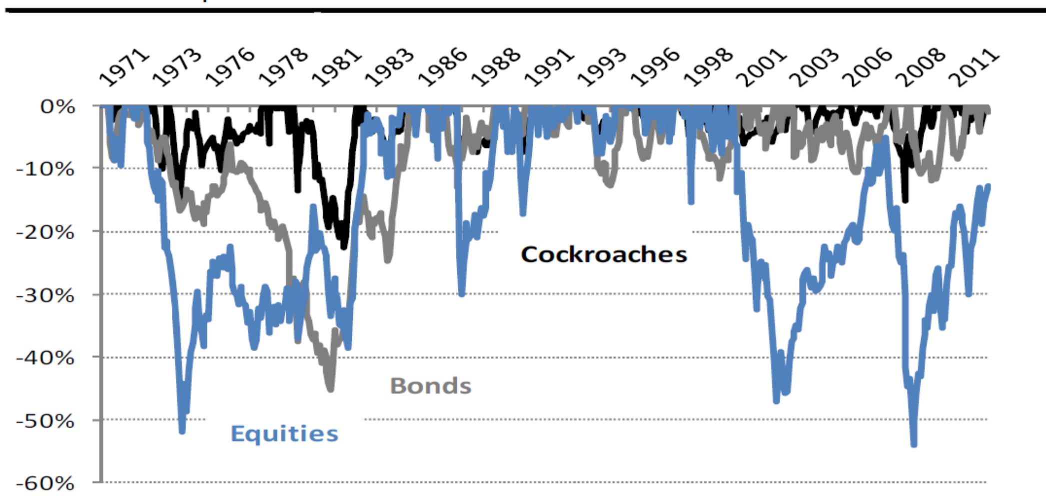
"Cockroaches may not be able to build nuclear bombs. But they can withstand nuclear war. They ***survive***. Don't get me wrong. Thriving is great. Prospering isn't bad either. But neither mean much if you're unable to survive. To my mind, therefore, capacity to survive has to be the starting point when thinking of success. It's all about robustness really, and on this metric cockroaches are tops.

"The oldest cockroach fossil is 350 million years old, which is quite remarkable when you think about it. We humans have been around for around for a mere fifty thousand years (so we're one seven thousandth as successful as cockroaches). According to the record of the rocks, cockroaches first appeared just after the second of the earth's five mass extinctions (defined as the loss of 75% of all species). In other words, that means they survived the third, fourth and fifth mass extinctions which followed, the last one being the Cretaceous event which wiped out the dinosaurs. They can go without air for 45 minutes, survive submerged underwater for half an hour, survive freezing temperatures and withstand fifteen times more radiation than humans. They eat pretty much anything, including the glue on the back of stamps. And when that runs out, they can last a month without anything at all before finally starving."

And the cockroach behaves according to the most banal of operating algorithms: if it detects a gust of wind that might signal an approaching predator, it simply scuttles off in the opposite direction. So, Dylan goes on to ask, ***if*** we were cockroaches (most bankers reading this need not even ask the question), how would we go about assembling a similarly robust portfolio ?

"A real cockroach would survive the 1970s. It would be inflation resistant, deflation resistant, credit inflation resistant, credit deflation resistant.. despite having "no view" on which scenario was more likely at any point in time. So let's assume our cockroach has no view. It doesn't know what's around the corner so it doesn't make any bets. It holds half of its capital in real assets, the other half in nominal. Of course, being a cockroach, it doesn't know if capitalism is about to collapse or flourish. So it divides its nominal and real buckets further into productive and unproductive assets. It puts 25% of its portfolio in equities, 25% of its portfolio in gold, 25% of its portfolio in government bonds, and 25% in cash."

A true cockroach portfolio survived the 1970s

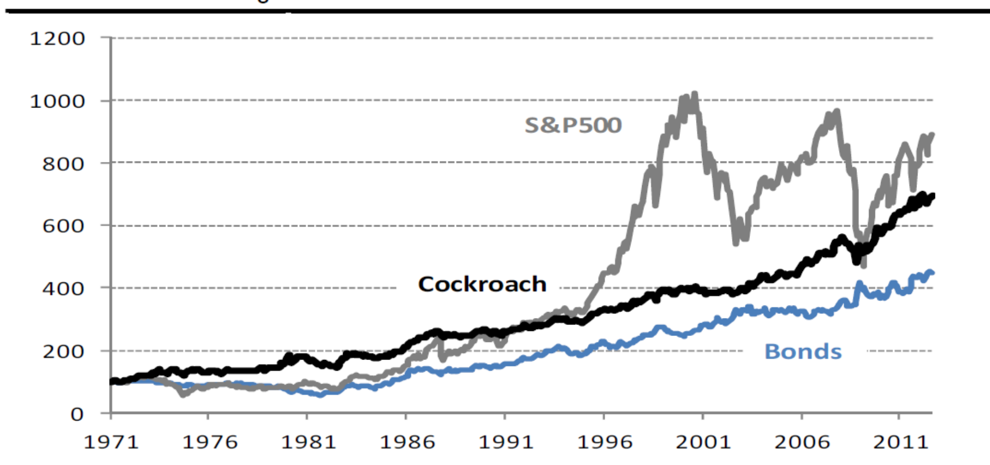


Source: SG Cross Asset Research

This naïve asset allocation strategy proved very robust during the inflationary 1970s – compared with the drawdowns from bonds or equities. As Dylan says, "..such a portfolio offers some very real protection against the vagaries of an unknown future. Real drawdowns during each regime were significantly mitigated with the cockroach-like strategy of simplicity, agnosticism and robustness."

And the returns from the 'cockroach portfolio' have been pretty tidy, too:

Cockroaches for the long run!



Source: SG Cross Asset Research

5% real since 1971, versus 5.5% in equities and 4% in government bonds (themselves now in a distorted bubble, in our view).

Our own investment strategy is not unlike that of Dylan's cockroach. It is deliberately somewhat naïve. We allocate across bonds (check) – although, since we believe we can add value to our clients from operating in an index-unconstrained manner rather than blithely tracking an index, we can concentrate on genuine value as opposed to mirroring an index that reflects the views of greater fools than ourselves. We allocate across equities (check) – but the same point about index-tracking (or rather, not index-tracking), and seeking explicit value, repeats. We allocate to gold (check) as part of a desire to hold real assets. And to complement Dylan's asset selection, we also allocate to strategies that are uncorrelated to each of the other asset classes. That, for us, is a better bet than allocating to cash alone – although we acknowledge the liquidity flexibility and optionality that cash confers.

All very well in theory, perhaps, but how has this worked in practice ? We manage an offshore fund, CLI Spa Core Portfolio, that operates on the same basis, seeking capital preservation and prudent returns from allocating to high quality debt; defensive equity; uncorrelated funds; and real assets. Its returns from inception in August 2008 (just prior to the Lehman Brothers collapse) are shown below:

A - CLI - SPA Core Portfolio in GB [17.20%]

19/08/2008 - 07/12/2012 Data from FE 2012

Discrete performance (%)					
	YTD	2011	2010	2009	2008
CLI SPA Core Portfolio	+6.3	-4.4	+18.4	+8.2	n/a

But the past may not be prelude, and our regulator requires us to state as much. It should be clear to any longstanding readers that we nurse grave fears for the future. So we have, at least, two choices. We can vote in favour of the asset specialists who, putting the wrong end of the telescope to a blind eye, suggest that there are no problems ahead, and no bubbles visible. Or we can vote in favour of a somewhat naïve strategy that allocates ***almost*** slavishly to a diversified array of disparate asset types and that then attempts to pick value in those dusty, neglected

corners where it might still exist. We are more worried about risk than we are greedy for return. If that makes us cockroaches, we can certainly live with the label.

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10th December 2012.

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