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

28th January 2013

# Nobody knows

"Economists, like royal children, are not punished for their errors."

- James Buchan.

**We lost another** client last week. This makes a grand total of ***two*** clients who have left us over the past year, not because we lost them money, but because apparently we didn't make them enough. Since the rate at which we are attracting brand new clients is comfortably outpacing the rate at which we lose relatively new clients, this shouldn't be an immediate cause for concern either for us or for our clients, but it is a little galling nonetheless. We take some pains to try and communicate our philosophy and process on a regular basis, but such communications for some clients are evidently insufficiently compelling when set against a bull market in common stocks and other risk assets. The market's going up ! And what have you guys done for me lately ?

There are only a handful of truly great books on investing out there, and the late Peter L. Bernstein's 'Against The Gods' is one of them. 'Against The Gods' is, effectively, a biography of risk. We first chanced upon it, if memory serves, in late 1999, when the dotcom insanity was still in full swing. Our then employer, Merrill Lynch Private Banking, had just handed every employee a copy of Glassman and Hassett's 'Dow 36,000'. Guess which book is better. But time moves on. We also moved on, and Merrill Lynch ended up blowing itself up and being merged via a shotgun wedding with Bank of America. *Sic transit gloria mundi*. (This isn't a rant against Merrill Lynch in isolation. They may not have been a good company, but they were in good company. Even Goldman Sachs blew itself up, and unlike Lehman Brothers was only rescued by the Federal Reserve rather mysteriously allowing it to convert into a bank – which it wasn't and isn't – and suckle directly from the Fed teat. Think about that emergency rescue the next time you see reference to "talent" at Goldman Sachs. Talent for sharp-elbowed self-preservation, perhaps. But we digress.)

'Against The Gods' is worth reading in its entirety, but as anyone who has been subject to our investment pitch will testify, we are fond of highlighting one specific quotation therein. Daniel Bernoulli (1700-1782) was a Swiss mathematician and true 'Renaissance man' who has a good claim to be the world's first behavioural economist. Bernoulli once said that if you are managing money for wealthy people,

"The practical utility of any gain in portfolio value inversely relates to the size of the portfolio."

In plainer English, if you are managing money for wealthy people, just don't lose it. Wealthy people, like everybody else, like to make a decent return, but they don't need to take outlandish risks since they're already wealthy. So the requirement to make a "decent" return is mitigated by the likely regret at eroding a meaningful capital base. In other words, capital preservation – albeit in real terms to have any genuine value – trumps aggressive capital growth.

This may hold for all investors, but we think it has almost universal application to the wealthy. Why jeopardise the entire pot if the pot is already meaningfully large ? This provokes another question, at least in our mind, namely what do we mean by risk ? Unlike the regulator, which defines risk as whatever it is worried about on any given day, or as what IFAs are selling most successfully, or as price volatility, we use a very specific primary definition of risk: the risk of permanent loss of capital.

So our investment practice is quite deliberately not focused on capital growth in isolation, but on capital preservation and growth thereafter, along the same basis that the long run is nothing more than a sequence of short runs, and if we can manage to preserve clients' capital tolerably well in the short runs, that aggregation of short run capital preservation and modest (occasionally high) growth will end up outperforming a sequence of aggressive capital gains with all the attendant substantial drawdowns.

How we divide the portfolio pie is probably atypical relative to most of our peers (we certainly hope so). We consciously try not to make overly subjective asset allocation calls. This is because, unlike most of our peers, we recognise that we cannot predict the future. What we do know is that a portfolio with meaningful allocations to four genuinely discrete asset types has a good chance of delivering superior risk-adjusted returns over a portfolio that is essentially split between stocks and bonds. Analyst and strategist Dylan Grice wrote about a very similar construct, the 'cockroach' portfolio, just before Christmas.

The 'cockroach' portfolio is named after one of nature's survivors. The cockroach has survived three of the world's five mass extinctions and is virtually indestructible. How, then, would a cockroach go about constructing a portfolio with the same robustness ? Since the cockroach also cannot predict the future, it simply tries to hedge against as many risks as possible. Dylan's cockroach therefore ends up with a very simple but remarkably robust asset allocation, consisting of:

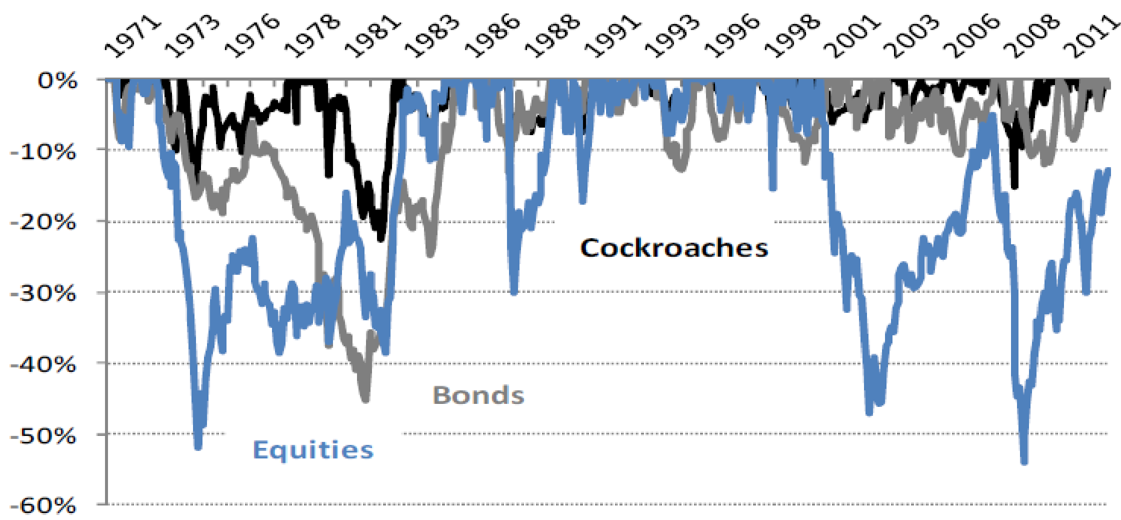
- 25% cash
- 25% government bonds
- 25% equities
- 25% gold.

Cash is a hedge against overconfidence on the part of the cockroach-as-asset-manager (this category probably contains legions of real world examples). Government bonds are a hedge against deflation (admittedly assuming a "normal" bond market environment, which sadly we objectively do not have). Equities are a claim against the presumed real growth of the economy. Gold is a hedge against people like Ben Bernanke.

And the 'cockroach' portfolio is amazingly robust. Since 1971, the cockroach's portfolio would have generated annual real returns of +5%. That is pretty saucy set against a portfolio of 100% equities (+5.5%) and 100% bonds (+4%). But that is only the start of it.

How would the cockroach's portfolio have fared during moments of massive, actual crisis ? Again, the cockroach fares very well during market crashes with his naïve multi-asset strategy:

A true cockroach portfolio survived the 1970s

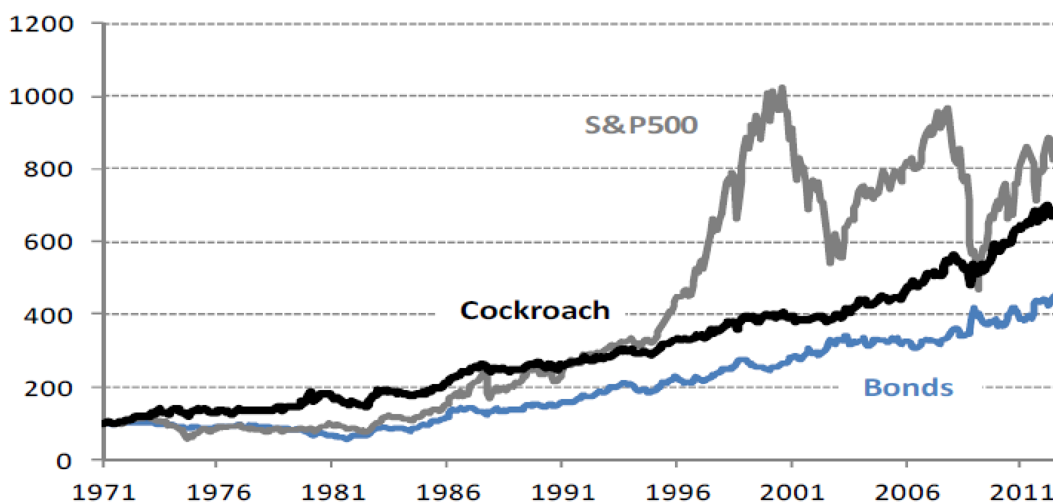



Source: SG Cross Asset Research

During the 1970s, the cockroach had a far smoother ride than 100% equity or bond investors, as the chart above shows. Good job we're not in an environment like the 70s, with banking failures, a debt crisis, stagflation and widespread political drift..

But taken in the round, the cockroach enjoyed (will enjoy ?) extremely attractive overall returns with a fraction of the risks incurred by his racier peers.

Cockroaches for the long run!




Source: SG Cross Asset Research

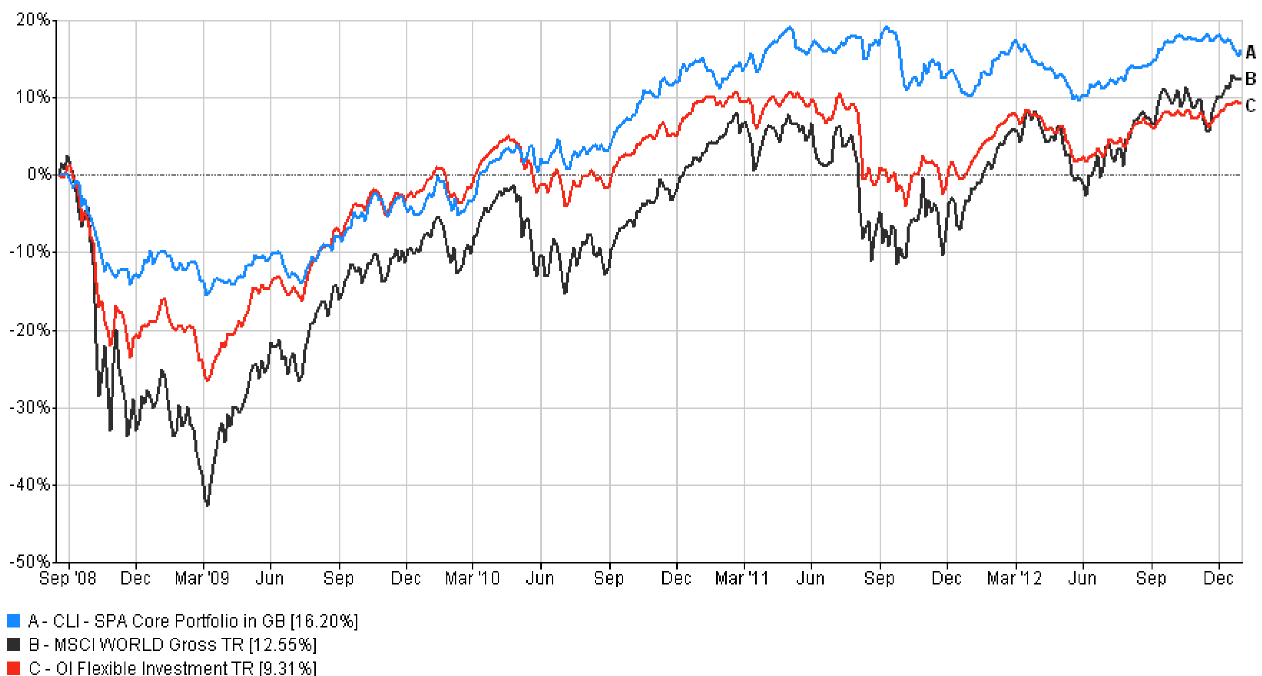
Please note, you do not need to be a cockroach to benefit from the 'cockroach' portfolio.

Our own take on Dylan's cockroach is a little different, but the similarities outweigh the differences. The percentages vary, but we remain committed to four discrete asset classes too:

- Objectively high quality credit
- Attractively valued equities
- Uncorrelated funds, specifically systematic trend-followers
- Real assets, notably the monetary metals, gold and silver.

How has our own version of the 'cockroach' portfolio fared during the vicissitudes of the last four years ?

**PFP Wealth Management's CLI Spa Core Portfolio (blue) versus MSCI World Equity (black) and Offshore Flexible Investment Sector (red), Sep 2008 to Dec 2012**




This is admittedly within a fund, but unlike most funds, the fund in question is designed to accommodate clients' life savings. Compare the drawdowns, for example. Evidently other funds out there will have generated superior returns – but at what risk ?

We think that this four-factor model has huge advantages over the traditional, more subjective model that most wealth managers use, which is heavily dependent upon entirely subjective market timing and also heavily dependent on a largely binary decision between equity ("good", now) and bonds ("bad"). The four-factor model is a great protection against asset manager hubris and overconfidence.

These are dark times for many asset managers. We doubt if we're alone in struggling to retain some clients in the face of yet another 'risk on' spasm in the financial markets. Investors have very short memories. The same investors who wanted out of stocks in 2008 because the world seemed to be hurtling towards an end are now the ones wanting back in when barely any of the problems facing the world in 2008 have been resolved, and when most have deteriorated markedly, and the ones that have been seemingly resolved have only reached that stage due to extraordinary inflationary monetary stimulus (**$6 trillion** or so in base money creation just waiting on bank balance sheets to morph into real price inflation ?). Admittedly, there is no real correlation between stock market returns and economic growth, so the fact that the western

economies have now gone conclusively ex-growth is not an automatic reason to shun stocks. But the fact that global credit market debt stands, according to Kyle Bass, at some 340% or so of global GDP – a level never reached before in world history – has to be cause for concern. Our thesis remains that the western economies now require constant economic growth purely to service that mountain of debts. The growth won't happen, so the debt service now won't happen either. Someone is going to get shafted. We just don't want it to be us.

Perhaps our recently departed clients know something we don't. They may well thrive out of their newly raised allocations (one presumes) to equity risk. Nobody knows. But we're still content to play our long game of capital preservation – come what may – with a paranoiac's attitude to risk. And those two words – Nobody knows – should be sellotaped to everybody's computer screen or TV screen or mobile phone screen for the duration of this long emergency. We don't know either what happens, in debt markets or currency markets or stock markets or the economy, so we're resigned to making our own modest subjective allocations to each of those four core asset classes, and within them then only working with either (subjectively) the best managers we can find, or the most attractively valued instruments we can find. Uncertainty's a bitch. But certainty, in this financial environment, is even more absurd.

Tim Price
Director of Investment
PFP Wealth Management
28th January 2013.

Follow me on twitter: timfprice

Email: tim.price@pfpg.co.uk

Homepage: http://www.pfpg.co.uk

Weblog: http://thepriceofeverything.typepad.com

Bloomberg homepage: PFPG <GO>

Important Note:

PFP has made this document available for your general information. You are encouraged to seek advice before acting on the information, either from your usual adviser or ourselves. We have taken all reasonable steps to ensure the content is correct at the time of publication, but may have condensed the source material. Any views expressed or interpretations given are those of the author. Please note that PFP is not responsible for the contents or reliability of any websites or blogs and linking to them should not be considered as an endorsement of any kind. We have no control over the availability of linked pages. © PFP Group - no part of this document may be reproduced without the express permission of PFP. PFP Wealth Management is authorised and regulated by the Financial Services Authority, registered number 473710. Ref 1004/13/JB 280113.