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Value investing

"Sir, With reference to your report "Leading bullion bank declares end to gold's decade-long rise" (February 2): Oh dear ! Why make it complicated ? If you expect lots of monetary expansion over the coming years, paper money's value can be expected to decline. If you expect governments to stop trashing their currencies, it probably won't. That is what the future price of gold will reflect, pure and simple."

- Alasdair Macleod, Head of Research, GoldMoney, in a letter to the Financial Times.

"The world's central banks last year bought 534.6 tons of gold in 2012, the most since 1964, as global gold demand hit a record value level, the World Gold Council said Thursday in a quarterly report. Purchases by central banks for the full year rose 17% compared with 2011, while fourth-quarter purchases of 145 tons marked a 29% rise from the same period a year earlier."

- MarketWatch / The Wall Street Journal, 14th February 2013.

"Where is the wisdom we have lost in knowledge ?
Where is the knowledge we have lost in information ?"

- From 'The Rock' by T. S. Eliot.

Price is what you pay; value is what you get. Warren Buffett's rightly celebrated aphorism carries an especial resonance when, courtesy of near-zero interest rates and global competitive currency debauchery, it is increasingly difficult to assess the value of anything, as denominated in units of anything else. To put it another way, the business of rational investing becomes almost existentially problematic when a significant number of market players are pursuing maximum nominal returns without a second thought as to the real value of those returns. Hedge fund manager Kyle Bass alluded to this problem recently when he pointed out that the Zimbabwean stock market had been the last decade's best performer, but that owning the entire index would only buy you three eggs. It is not just Zimbabwe. Markets everywhere, in just about everything, have now decoupled not just from their underlying economies but from reality.

There are signs that Buffett himself has decoupled from the value investing philosophy that made him the world's most successful investor. Berkshire Hathaway is paying almost 20 percent more

than Heinz stock's all-time high in the deal announced last week, and the equivalent of 21 times 2013 earnings as opposed to the 16 times multiple which is the last decade's average. Say what you like about the business, but Buffett has not bought it cheaply. It may be that with $47 billion in cash as at end 2012 burning a hole in his pocket, Buffett was simply impatient to buy something. Indeed, at 82, Warren Buffett has inadvertently displayed his mortality.

To us, the more intriguing aspect to Warren Buffett is that he gives every indication of not understanding money. Now ***that*** is irony on stilts. For sure, gold "gets dug out of the ground in Africa, or some place. Then we melt it down, dig another hole, bury it again and pay people to stand around guarding it. It has no utility. Anyone watching from Mars would be scratching their head." Note that phrase: "It has no utility". But utility, usefulness, purpose, value comes down to context. Last week we quoted at some length from Adam Fergusson's 'When Money Dies', a shattering account of the Weimar hyperinflation. Context is all. Or as Fergusson bleakly and movingly puts it,

"In war, boots; in flight, a place in a boat or a seat on a lorry may be the most vital thing in the world, more desirable than untold millions. In hyperinflation, a kilo of potatoes was worth, to some, more than the family silver; a side of pork more than the grand piano. A prostitute in the family was better than an infant corpse; theft was preferable to starvation; warmth was finer than honour, clothing more essential than democracy, food more needed than freedom."

Buffett is chained to a rock of convention. He is hardwired to pursue money and he is evidently very good at that pursuit. But he is not well programmed to consider the relative utility of money or its attributes as a lasting store of value. It is a somewhat sterile exercise to become a billionaire if one cannot afford the price of a cup of tea. He is now an investor in decline (and one we think who has sold his soul to become a shill for the US administration, notwithstanding his obvious and indeed hardly concealed philanthropy). The history of recent years would tend to support the declining Buffett thesis, which is after all simply a recognition that the tree cannot grow to the sky. Since 2000, the price of gold has outperformed the price of Berkshire Hathaway stock by over 300%. No particular surprise, then, that he should hate the stuff.

And many investors are losing faith in gold on the basis, presumably, that its price as expressed in US dollars has recently declined. Context is all. Express the price of gold in another currency, the Japanese Yen, and gold looks relatively buoyant:

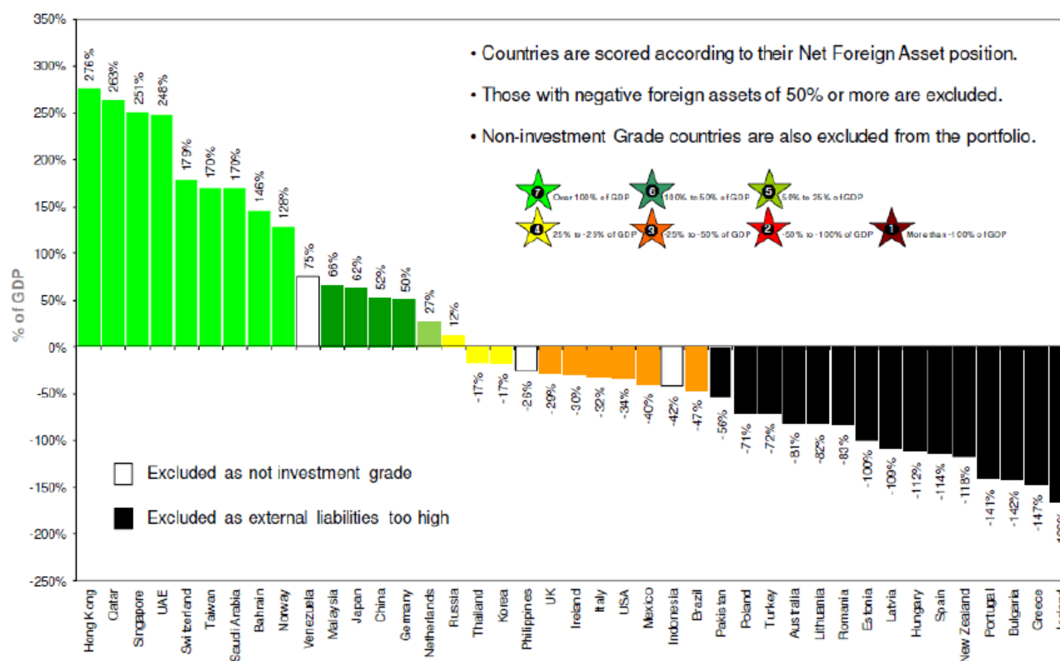
Gold price in Japanese Yen, last 12 months

Source: Bloomberg

So it comes down to what sort of money you want.

We have been toiling in the capital markets trenches for nearly a quarter of a century. For most of that time, we have had either very little or zero consciousness of any sort of roadmap for assessing currency values. Since all fiat currencies have no tangible backing, one is forced to make a subjective assessment of economic fundamentals and anticipated investor preference and capital flows. But since the credit bubble burst spectacularly in 2007/8, we have had that roadmap. Longstanding readers will recognise the following chart.

Net foreign assets as % GDP



Source: Stratton Street Capital LLP calculations (as at Jan 2011) and extended version of the External Wealth of Nations Mark II database developed by Lane and Milesi-Ferretti (2007)

The chart is used by fund managers at Stratton Street Capital to help assess sovereign credit quality. They suggest, and we believe, that it also has merit in assessing likely currency movements too. In a global deleveraging that is likely to persist for some years, the heavily indebted countries (shown in black in the chart above) will desperately need to attract foreign capital to help service their heavy debt loads. To improve their terms of trade, they are likely, in turn, to want to devalue their currencies (inasmuch as currency devaluation does not deteriorate into a disorderly global mess, which may yet transpire). So in sum, capital is likely to flow – perversely, admittedly – from the black countries (clapped out debtors) that desperately need money, towards the green countries (objectively more creditworthy borrowers) that don't. The shorter version: buy Singapore dollars and short New Zealand dollars, etc. etc.

If you're trying to protect your capital, it helps to know which currency to hold it in. This chart is likely to be a useful roadmap. But the one currency it doesn't highlight is gold, although we take some pains to. There is an increasingly disorderly currency war going on out there, and the advantage of gold is in abandoning the battlefield altogether. As fund manager John Butler points out, there are numerous reasons for holding hard assets:

“The colossal global debt problem, associated currency wars, looming trade wars and possible capital controls collectively threaten the real value of financial assets generally through some combination of devaluation, default and inflation. In this unusual and unfortunate situation, commodities provide a form of insurance. They cannot be ‘printed’ or otherwise arbitrarily devalued. They cannot default. They will always find some demand. Indeed, amid trade barriers and capital controls some basic commodities taken for granted today may command a large premium due to supply shocks.

“As it stands now, however, commodities appear cheap relative to financial assets. Equity markets have risen strongly of late, leaving commodities the most undervalued in relative terms since 2008. Bond markets may have sold off slightly in recent weeks but in any reasonable historical comparison remain extremely expensive as a result of unprecedented and unsustainable central bank buying.

“It is impossible to know just which commodities are most likely to rise in price. As a form of alternative money, gold and silver are likely to rise, in particular if there is even a partial official remonetisation of these metals as a replacement for highly unstable fiat currencies. But trade barriers could restrict the flow of oil and foodstuffs, pushing up their prices to unprecedented levels.

“The best action investors can take is to diversify their exposure across a broad range of essential commodities and those companies that produce them domestically and abroad. These companies are likely to retain their pricing power amid trade wars, although they may be subject to nationalisation in extreme cases.”

We think Buffett and his ilk in the pursuit of dollar maximisation in a very narrow sense are being penny wise but pound foolish. To be a true value investor, it helps to have values.

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