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17th June 2013

Permanence

"When you give up the search for certainty, an enormous burden is lifted from your shoulders.

"The less you know - and the more honestly you recognize the limits of your knowledge - the more likely your investment programme will turn out okay. Humility is accepting that you don't know everything, or even everything about any particular topic, and it is an investor's most vital asset. Arrogance eventually ruins any investor."

- From 'Fail-Safe Investing' by Harry Browne.

In his book 'Fail-Safe Investing', the US investment analyst Harry Browne proposed what he called a 'Permanent Portfolio' which had the following characteristics:

- Safety
- Stability
- Simplicity.

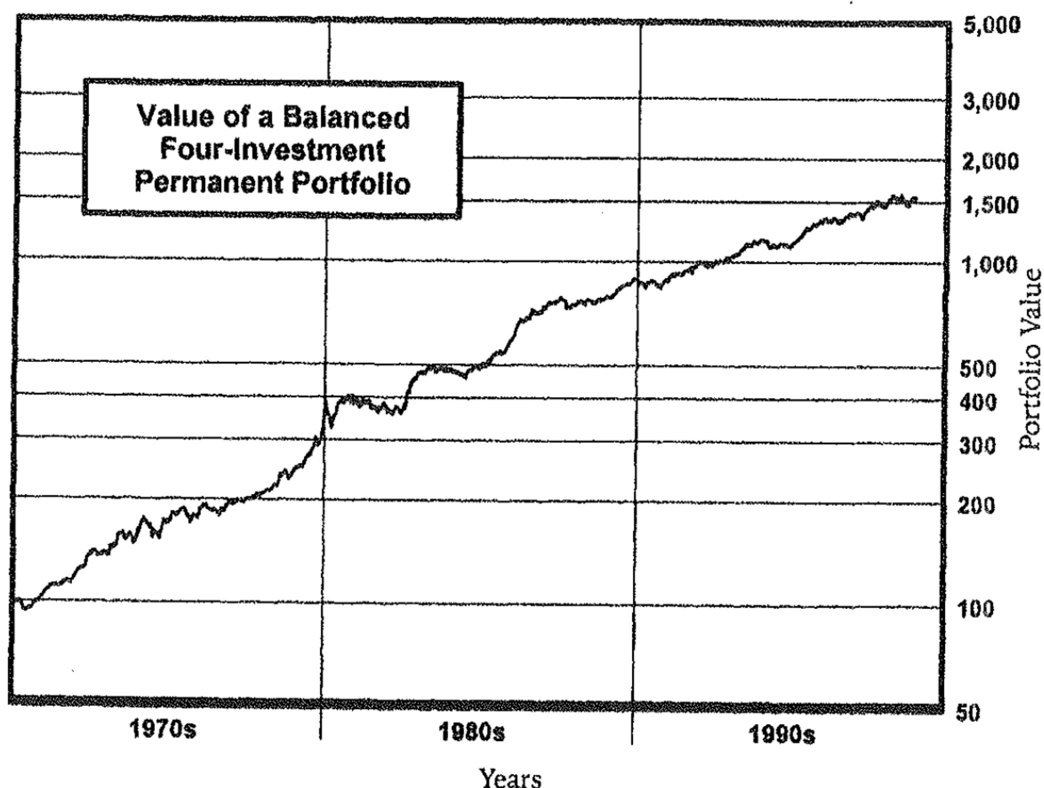
Each of these characteristics barely requires elaboration. Safety implies that the portfolio can protect the investor against "every possible economic future". Stability implies that whatever market circumstances, the portfolio's value should hold its own, incurring only modest falls. Simplicity implies that the portfolio largely looks after itself, requiring only the minimum expenditure of time in its oversight and maintenance. In terms of particular economic or market environments, Browne highlighted four:

- Prosperity, in which interest rates are usually falling, along with unemployment;
- Inflation, during which consumer prices are generally rising;
- Tight money or recession, during which money supply growth slows;
- Deflation, during which the purchasing power value of money rises.

Browne went on to recommend four types of investments that would cater to these four distinct environments:

- Cash, which is most profitable during a period of tight money;
- Bonds, which can be expected to profit when interest rates collapse during a deflation;
- Stocks, which thrive during a period of prosperity but which tend to do poorly during periods of inflation, deflation and tight money;
- Gold, which can be expected to do well during times of intense inflation – in the 1970s, for example, just before 'Fail-Safe Investing' was written, the price of gold rose by 20 times.

Which all sounds fine in theory. How did this 'Permanent Portfolio' fare in reality ? The graph below shows the returns from Harry Browne's diversified model from January 1970 to December 1998 (my edition of the book was published in 1999):



Source: 'Fail-Safe Investing' by Harry Browne (St Martin's Press, 1999)

His 'Permanent Portfolio' provided an average gain of 9.9% per annum, or 4.5% per year above inflation.

"The period covered by the graph encompasses most of the economic environments your portfolio might have to face. The 1970s were plagued with inflation. Prosperity reigned during much of the 1980s and 1990s. And there were recessions in 1970, 1973-75, 1980, 1981-82, and 1990-92. The only economic climate not included in the period was an outright deflation, such as America suffered during the early 1930s."

According to Browne's three standards, how did his 'Permanent Portfolio' fare ?

"1. Safety: The portfolio continued growing through every economic environment it faced. It even gained value (in real, after-inflation terms) during the inflationary 1970s. With such a portfolio, you know you're safe no matter what may come.

"2. Stability: A striking feature of the graph is the Permanent Portfolio's stability. It achieved steady growth – sheltering its owner from the extremes that most investors faced. In 29 years the portfolio lost value in only three years – 6.2% in 1981, 0.7% in 1990, and 2.4% in 1994. And those were years in which most investments lost value. In particular, 1981 was a terrible year for ***every*** major investment – stocks, bonds, foreign currencies, commodities, gold and silver – and most investors took a terrible beating that year. Each of the Permanent Portfolio's three losing years was followed by rapid gains that overshadowed the small losses.

On October 19, 1987, when the Dow Jones Industrial Average fell 22.6% in one day, the four-investment Permanent Portfolio lost only 4.3% of its value. Despite the stock market crash, the portfolio finished 1987 with a gain of 5.3% for the year.

"3. Simplicity: For most investors, this portfolio requires no more than one short day to set up. Thereafter, you need to monitor it ***only once a year*** – merely to determine whether changes in investment prices have unbalanced the portfolio's mix of investments.

"The portfolio's gains were achieved without foreseeing the future, without dependence on a guru or system to move with split-second timing from one investment to another – in fact with no switching among investments at all."

The beauty of the 'Permanent Portfolio' is that it removes all subjectivity from the investment process. It assigns the investor's capital across four asset classes – and sticks to them, simply rebalancing once a year back to Browne's 25% allocation to each class. It completely removes the investor's dependence on his or her own (or a third party fund manager's) ability to time the market.

Times change, of course. We will never know what Harry Browne might have thought of our current market environment (he died in 2006). But we have our own views. And so we have, effectively, adapted his 'Permanent Portfolio' concept in line with the challenges of the financial arena today. Most notably at variance from his original proposal, given that cash deposit rates are at their lowest level in history, we allocate the cash component instead to systematic trend-following funds. Why ? For a number of reasons:

Their historic and anticipated correlation to stock markets is approximately zero;

Systematic trend-following is perhaps the only active asset management approach that makes no attempt to predict the future, but merely responds to the price signals of the past;

Systematic trend-followers have shown a key ability in treacherous markets not only to preserve investor capital but actually to grow it.

Take the performance of Winton Futures Fund, for example, one of the largest systematic trend-following funds in the world. From inception in 1997, the fund has so far only incurred two losing years, namely 2009 and 2012. In 2009 the fund lost 4.63% of its value, and in 2012 it lost 3.56% of its value. Over a 16 year period, we can live with that sort of frequency of loss. But then consider its performance in 2008 – when the S&P 500 Index ***lost*** 37% of its value. Winton Futures generated a ***positive*** return of 20.99%. We can live with that sort of negative correlation to equities, too.

Monthly performance of Winton Futures Fund USD B Class Fund, 1997 - 2013

NET MONTHLY RETURNS (%)

e = estimate

	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
Jan		1.50	-1.39	-3.96	4.38	-10.13	5.95	2.72	-5.38	4.20	3.86	3.85	0.99	-2.64	0.08	0.63	2.51
Feb		3.27	3.61	1.72	0.56	-6.04	11.95	11.56	6.58	-2.58	-5.93	7.95	-0.21	2.33	1.51	-0.83	0.17
Mar		7.38	-3.98	-3.28	7.09	12.62	-10.80	-0.80	4.64	4.01	-3.95	-0.66	-1.64	4.91	0.25	-0.68	2.66
Apr		-1.63	10.51	2.06	-5.31	-3.76	2.45	-8.62	-4.21	5.66	6.46	-0.99	-3.01	1.75	3.00	0.12	3.41
May		8.53	-8.39	-0.26	-2.61	-3.96	10.19	0.28	6.62	-2.94	5.05	1.99	-2.03	-1.01	-2.16	-0.22	-2.40
Jun		2.97	5.29	-1.27	-2.66	7.95	-5.20	-2.96	3.13	-1.17	1.91	5.06	-1.26	1.47	-2.51	-3.17	
Jul		1.51	-2.01	-4.58	0.66	4.71	-0.68	1.33	-1.85	-0.47	-1.18	-4.63	-1.52	-2.78	4.59	4.41	
Aug		10.99	-3.47	3.23	0.56	6.04	0.62	3.09	7.63	4.54	-0.88	-3.00	0.32	4.78	1.43	-1.29	
Sep		4.51	-0.17	-7.76	4.64	7.63	0.26	5.14	-6.17	-1.10	6.99	-0.41	2.85	0.94	0.16	-2.18	
Oct	-12.97	-5.70	-6.20	2.09	13.75	-7.96	4.72	4.03	-2.95	1.48	2.52	3.73	-1.59	2.51	-2.59	-2.54	
Nov	9.96	1.15	13.93	7.33	-7.10	-0.69	-2.48	6.37	7.32	3.24	2.42	4.97	5.12	-2.01	0.97	1.00	
Dec	8.14	9.50	9.04	16.81	-5.15	14.16	10.27	-0.19	-4.37	2.14	0.24	2.10	-2.45	3.75	1.65	1.36	
YTD	3.49	52.18	15.07	10.44	7.12	18.34	27.76	22.63	9.73	17.83	17.97	20.99	-4.63	14.46	6.29	-3.56	6.39

Source: Winton Capital Management Ltd

But in most other respects, we pursue an approach that is philosophically close to Harry Browne's. We allocate to the same other asset classes (bonds, equities and gold), albeit we attempt to add value relative to the relevant indices by selecting investments on a bottom-up basis explicitly biased to deep value principles. So in the middle of a global bond bubble, we have no exposure to overvalued government bonds issued by fundamentally bankrupt governments; rather, we see merit in holding debt issued by objectively creditworthy sovereigns, particularly if those debt instruments yield significantly more than the so-called 'risk free' markets like the US, the UK and so forth. And in the middle of a stock market being buffeted about by hopes and fears over quantitative easing, we see merit in holding value stocks on unchallenging multiples, or allocating to specialist managers pursuing the same objective in foreign markets with superior fundamentals (read: Asia). And unlike the naïve Permanent Portfolio (the word naïve here not meant as a criticism but as a straightforward assessment of its artless simplicity), we endeavour to add value by means of reweighting the portfolio in favour of compelling valuations and away from obvious overvaluation – which means that quite shortly we will be reducing our bond exposure in favour of value equity overseas. But if the Permanent Portfolio approach has real value, and we believe it does, we will always have some skin in each game – because otherwise the principle of diversification will be entirely sacrificed on the altar of overconfidence.

Bullion and gold mining stocks have admittedly given us no shortage of volatility over recent months, but if the history of the Permanent Portfolio has any meaning, it shows that it's worth persevering when the market goes temporarily against you. The irony of gold's recent correction is that it's occurred when the rationale for our holding the asset (insurance against systemic risk in the banking system and more specifically against global currency devaluation) has become that much more compelling in the light of the Cypriot bank bail-ins and the latest iteration of über-QE from the Bank of Japan.

In short, there is only one thing that the Permanent Portfolio (or our modified version) can't do, and that's to protect investors from their own fears when markets – in bonds, gold or equities – move against them, perhaps quite aggressively, in the shorter term. But we never said it was a perfect world. In light of the most disorderly, not to say outright treacherous, financial environment this observer has encountered in over 20 years of working in the capital markets, the Permanent Portfolio approach has much to be said for it. As protection against overconfidence, or

a lack of confidence, or any ability to make informed inter-market calls during an extraordinarily volatile period, it is without equal. We give the last word to the late Harry Browne:

"Once you have a Permanent Portfolio, you'll be free to enjoy your life – a good deal freer than other investors are. You also will be freer to speculate if you want to, because the Permanent Portfolio provides a safety net beneath you.

"Although the Permanent Portfolio gives you the security of an insurance policy, it's better than insurance – because it doesn't cost you anything. Safety doesn't come at the expense of growth. In fact, over the period of your working life, you probably will earn a much better return on your Permanent Portfolio than many people achieve with complicated investment programmes.

"It's true that someone's investments will outperform your portfolio this year. And someone else's investments will outperform you next year. You may never have a year in which you're #1. But, most likely, each year it will be a different group of people who outperform you. And few investors will outperform your Permanent Portfolio over any stretch of years."

There's yet another reason to like the Permanent Portfolio approach. Provided the underlying investments are well and carefully selected, the ongoing requirement for portfolio turnover is extremely low. Since it doesn't require churning or the presumption of having an informed opinion about market direction, most stockbrokers will hate it.

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17th June 2013.

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