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Patsies

"Buried in all the horror of the payment protection insurance scandal.. was a killer detail showing how bad the banks are at helping the real economy. The PPI fines being paid by the banks are a form of transfer from the banks to the real economy: picture Smaug in *The Hobbit*, lying on his mountain of gold, being reluctantly forced to part with a few coins by Middle Earth's version of the Financial Conduct Authority. The recipients of the money do exactly what the banks/Smaug won't: they spend it on goods and services. The Office of Budget Responsibility is the body set up by George Osborne in response to the fact that people had stopped believing official Treasury pronouncements. In their response to last year's budget, the OBR included a modest boost to 'household consumption growth', i.e. people spending money, thanks to the effect of PPI repayments. The OBR's assessment of Osborne's other policies showed no effect on household consumption growth. So the OBR reckons that the PPI repayments have done more to help the economy than all the other stuff the chancellor is trying to do put together! Another body showed the effect of PPI fines to be a boost of 0.2 per cent to GDP: a significant figure at a time when GDP was hovering between zero and something with a minus sign in front of it. That's really amazing. The banks are so bad at their primary function, lending money, that it's better for the economy if they pay billions of pounds in fines to the customers they ripped off."

- The consistently excellent John Lanchester savaging our ever-useless banks in The London Review of Books.

As most English students will tell you, the term 'pathetic fallacy' describes the personification of nature, typically by despondent poets, or the treatment of inanimate objects as if they bore human characteristics. In matters of finance and investment, perhaps the best example of 'pathetic fallacy' is Ben Graham's coinage, Mr. Market. Warren Buffett goes on to explain the analogy in the Berkshire Hathaway 1987 Annual Report:

"Ben Graham, my friend and teacher, long ago described the mental attitude toward market fluctuations that I believe to be most conducive to investment success. He said that you should imagine market quotations as coming from a remarkably accommodating fellow named Mr. Market who is your partner in a private business. Without fail, Mr. Market appears daily and names a price at which he will either buy your interest or sell you his.

"Even though the business that the two of you own may have economic characteristics that are stable, Mr. Market's quotations will be anything but. For, sad to say, the poor fellow has incurable

emotional problems. At times he feels euphoric and can see only favourable factors affecting the business. When in that mood, he names a very high buy-sell price because he fears that you will snap up his interest and rob him of imminent gains. At other times he is depressed and can see nothing but trouble ahead for both the business and the world. On these occasions he will name a very low price, since he is terrified that you will unload your interest on him.

"Mr. Market has another endearing characteristic: He doesn't mind being ignored. If his quotation is uninteresting to you today, he will be back with a new one tomorrow. Transactions are strictly at your option. Under these conditions, the more manic-depressive his behaviour, the better for you.

"But, like Cinderella at the ball, you must heed one warning or everything will turn into pumpkins and mice: Mr. Market is there to serve you, not to guide you. It is his pocketbook, not his wisdom, that you will find useful. If he shows up some day in a particularly foolish mood, you are free to ignore him or to take advantage of him, but it will be disastrous if you fall under his influence. Indeed, if you aren't certain that you understand and can value your business far better than Mr. Market, you don't belong in the game. As they say in poker, "If you've been in the game 30 minutes and you don't know who the patsy is, *you're* the patsy."

To extend Buffett's analysis, the problem we have today is that Mr. Market has been replaced by Mr. Bernanke (and his associates Mr. Carney, Mr. Draghi and Mr. Kuroda). So now, we've been in a game of markets-as-assessed-through-the-prism-of-QE for five years and counting, and we're ***all*** patsies.

But not all of us are attempting to forecast the future, or trying to decode and interpret the latest fatuous and contradictory pronouncements from Mr. Bernanke – which may be the more difficult of the two. Instead, we merely attempt to identify a) an appropriate asset mix across objectively high quality debt; deep value equity; uncorrelated funds, and real assets to satisfy our aspiration of capital preservation in real terms over the medium term, and then b) an appropriate array of investments that best caters to that asset mix. This approach is simultaneously 'top down' (in that we subjectively assess prospective risk / return attributes across asset classes) and 'bottom up' in that we attach huge significance to explicit value and what Ben Graham referred to as a 'margin of safety'. Regular readers and longstanding clients will recognise that this approach is, essentially, a modified version of what the 'Permanent Portfolio' has been doing, quite successfully, since its inception over 30 years ago. The 'Permanent Portfolio' "seeks to preserve and increase the purchasing power value of its shares over the long term" and it does so not by attempting to anticipate short term market activity or future economic events, but by endeavouring to limit downside risk whilst providing for the potential for profit ***in any environment***. It does this by investing in a diversified mix of uncorrelated assets, including gold, silver, real estate and natural resource stocks, growth stocks and government securities. Since inception in December 1982, the 'Permanent Portfolio' has delivered average annual total returns, before taxes, of 6.76%.

But – and this is an incredibly important but – even an objectively well-diversified portfolio does not deliver its returns in a straight line. This is clear from our own second quarter returns, which we note with some astonishment saw a greater drawdown than during the post-Lehman Brothers crash of late 2008. The culprit, of course, was gold.

Simply to ditch gold and related holdings, after the second largest sell-off in its recent history, would be to throw the baby out with the bathwater. Or to put it another way, to ditch gold now would be to suddenly forget why we went to the trouble of accumulating it in the first place. We were never buyers of gold because its nominal price was going up. We were buyers of gold

because it was and remains unique in the pantheon of investible choices in the modern world, namely as a long term store of purchasing power independent of political action, counterparty risk, credit risk, bank risk or money printing. These last non-characteristics are particularly relevant given that in no meaningful way whatsoever can the acute political, economic, banking, debt or monetary crises of the last five years be said to be closer to resolution. To put it another way, the reasons for holding gold as a unique form of currency, capital and portfolio insurance are unchanged if not strengthened by the economic and political developments of the last five years. That the gold price as expressed in US dollars is back to where it was in 2010 is missing a rather important point. To sell it now would be to relinquish all protection against a feared outcome which is still just as acutely to be feared (call that outcome 'disorderly currency collapse' if you like; plausible variants might include 'another 2008' or 'the sort of inflation that Martin Wolf considers impossible').

The beauty of the truly diversified portfolio approach is that it reduces or eliminates altogether the requirement of the portfolio manager to predict market direction (across multiple asset markets) or engage in speculative market timing. If it has a weakness, that weakness is shared by any investment in the world today – that Mr. Market might, for whatever reason, and for whatever length of time, take against its price. Since Mr. Market has been – at least temporarily – eclipsed by the likes of Mr. Bernanke, we take unusual comfort from an approach that is not dependent on its success from any subjective opinion with regard to either of them.

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