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

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Return of the cockroach

"Equities are the fine sliver of hope between assets and liabilities."

- Russell Napier of CLSA.

Last week, at the kind invitation of Gillen Markets, we made a presentation to investors in Ballsbridge, Dublin. Some edited highlights follow..

The problem: developed world governments and developed world banks are functionally insolvent. Total credit market debt stands at an eye-watering 360% of global GDP; for any single country to have its debt to GDP ratio at 250% is consistent with that country deficit-spending its way through a war. Many developed world countries have gone, in our view, definitively ex-growth. Their monetary authorities – the central banks – have run out of options, other than money-printing. There are realistically only three ways of dealing with an out-of-control debt pyramid. One is to maintain sufficient economic growth to service that debt; we consider this no longer realistic. The second is to default. Since we also operate within a debt-based monetary system (the money we use was lent into being by banks), Default = Armageddon, hence the ridiculous, Basil Fawlty-ish lengths to which central banks are going to keep the debt Titanic afloat. The third, which also happens to be the most politically palatable option, is to inflate the debt away. So the end-game seems clear. What is less clear is what happens before we get there, which could conceivably include a nasty period of debt deflation (with all the king's horses and all the king's men of QE adopted on a colossal scale, the Fed has had little success in triggering inflation in anything except the money supply and asset prices – the price index drawn from Personal Consumption Expenditures (PCE), the Fed's preferred measure of inflation, despite the $3 trillion expansion of the Fed's balance sheet, stands at just 1.1%.)

The question: how can we preserve our capital in real terms when a malign combination of inept central bankers and a global fiat (unbacked) currency regime, in which many of the major players are attempting to devalue their currencies, is inherently inflationary ?

Here are some of our favoured 'solutions' to the dilemma.

First, an aside on conventional economics. It's all nonsense. The American humourist P.J. O'Rourke once said that economics was

"An entire scientific discipline of not knowing what the hell you're talking about."

Someone then took him to task for the use of the word 'scientific'.

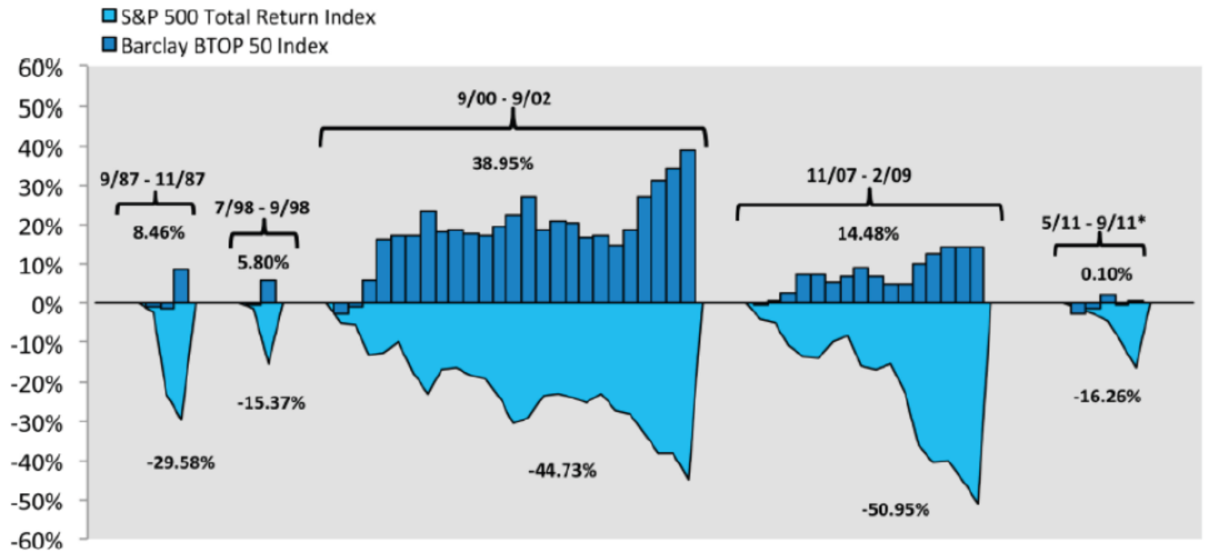
(We lay most of the blame at the feet of Léon Walras (1834-1910), a French idiot who serially failed at pretty much everything to which he directed his labours. In desperation, his father suggested that he try his hand at the then new 'science' of economics. Walras then proceeded to steal a bunch of theories from the world of physics and misapplied them to the emerging school of economics. The world in which we live is a complex place, and human beings no less so. Cramming the complexity of human life and interactions into an oversimplified theoretical model is like trying to cram a four foot jellyfish into a matchbox and then being surprised when the results end up being somewhat imperfect. Those who wish to learn more about Walras and the history of this sad, bastard non-science, which annually consumes thousands of intelligent students and turns them into morons, are invited to read Eric Beinhocker's excellent 'The Origin of Wealth'. Digression ends.)

So the investment situation is pretty challenging. Anything approximating to "risk-free" or low risk investments has been essentially destroyed by the ongoing banking crisis, QE and ZIRP (zero interest rate policies) throughout the West, which has made bank deposits and most government bond markets both dangerous and irrelevant to most practical-minded investors. In short, even to attempt to keep one's head above water in real terms requires taking a degree of (hopefully prudent) risk and being exposed to a bucketload of price volatility. We would also draw a keen distinction between price volatility (inevitable) and the risk of a permanent loss of capital (not inevitable, we trust).

(Another aside, in which we flourish the Austrian school sympathies which we wear upon our sleeve. If you wanted to perpetuate a depression, argued Murray Rothbard, you would pursue exactly the same policies being adopted throughout the ailing West. You would prevent the widespread liquidation of financial assets by lending money to shaky ~~banks~~ businesses. You would deploy as much money-printing as you could, to ensure that bad businesses remained on the scene like malodorous zombies. You would inflate further, preventing the necessary fall in prices. You would keep wage rates up, ensuring permanent mass unemployment. You would keep prices up, creating unsaleable surpluses. And you would stimulate consumption at the expense of saving, perhaps best expressed in the immediate aftermath of the September 11th attacks in the US, when then President George W. Bush advised everybody to go shopping. Digression ends.)

Diversifying by asset class has a long and successful history of navigating treacherous financial conditions. The late Harry Browne called it 'Fail-Safe Investing'. Dylan Grice, now of Edelweiss Holdings, compared it to the cockroach. But long story short, the essence of successful asset diversification is to deploy one's valuable capital across asset classes that each hedge, partly or wholly, against a different type of financial fate. Genuinely high quality bonds offer a degree of protection in a deflation. (Whether the bond market tide has started to go out is another question, and one not yet conclusively answered.) High quality (i.e. defensive) equities offer participation in any real economic growth out there, and can be expected to perform decently in an environment of low to moderate inflation. Assets that are genuinely uncorrelated to movements in the stock or bond markets – we like systematic trend-following funds, see below – evidently make sense as portfolio diversifiers. And exposure to real, tangible, non-financial assets (read: gold, for example) obviously has value in an environment of acute financial uncertainty and threat.

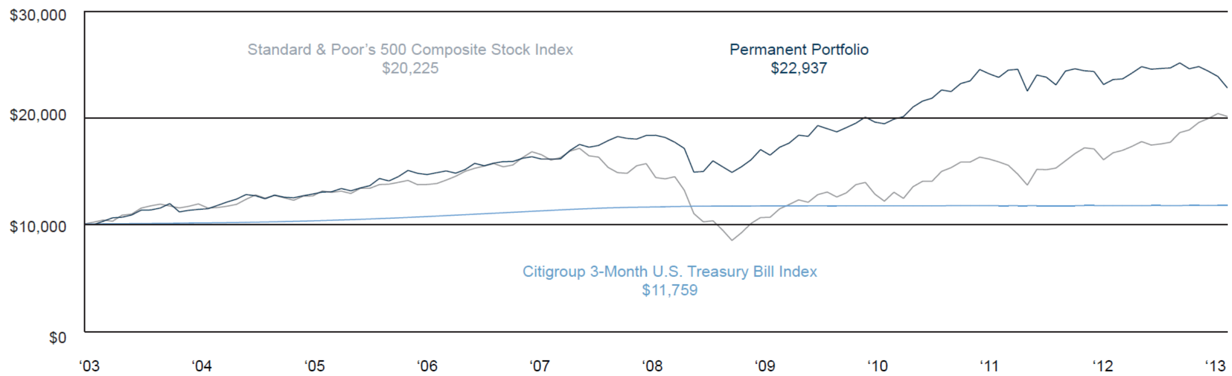
Trend-followers versus the S&P 500 Index during the S&P 500's worst five drawdowns since 1987



Source: Barclay Hedge

For those seeking more than just conceptual comfort from the diversified approach, a US mutual fund, the Permanent Portfolio, ticker PRPFX, is managed along very similar lines to those advocated by Harry Browne. This is a $12 billion fund invested in bullion (25%), US Treasury securities and similar assets (35%), Swiss franc assets (10%), real estate and natural resource stocks (15%) and growth stocks (15%). Its 10 year historic returns are shown below:

GROWTH OF $10,000 INVESTMENT (June 30, 2003 through June 30, 2013)



Source: Permanent Portfolio Family of Funds, Inc.

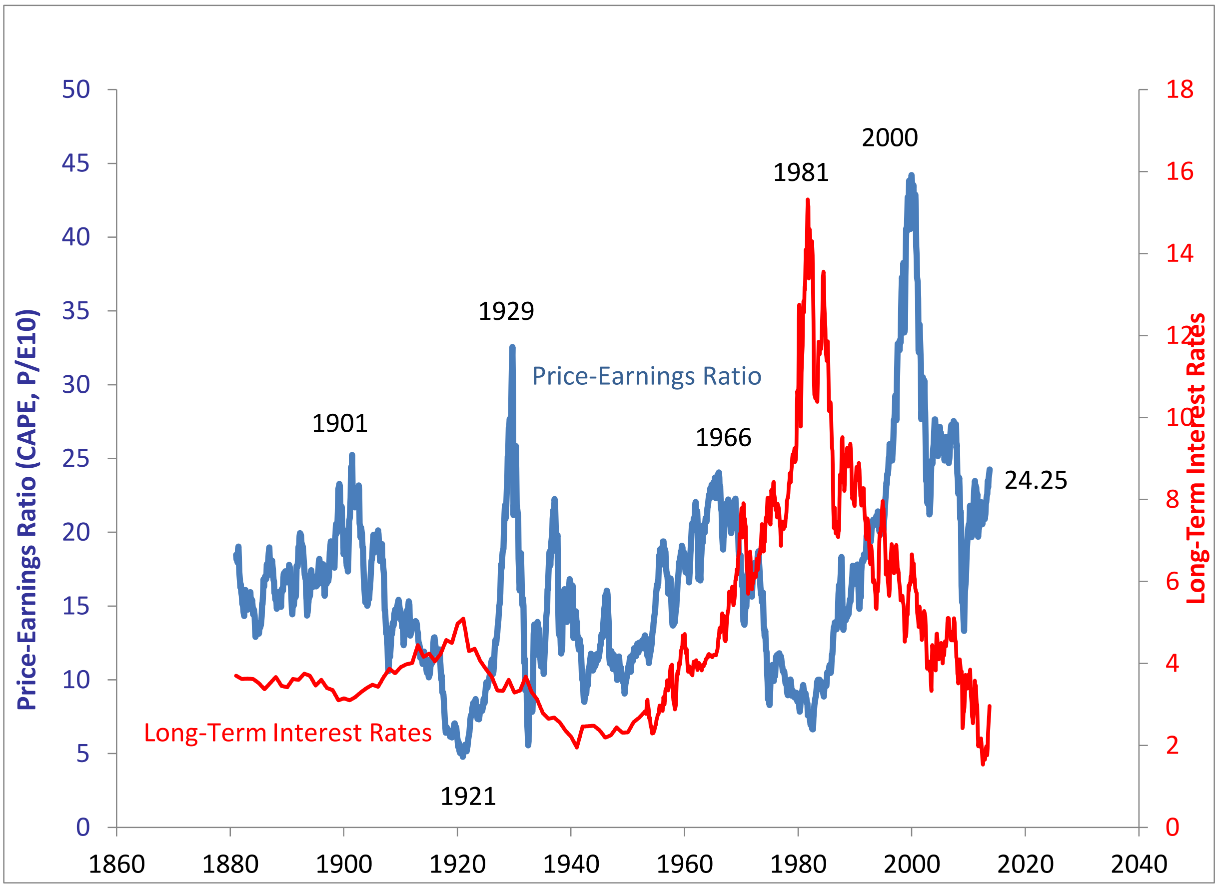
This multi-asset fund has, over the last decade, handily outperformed the broad US stock market, despite carrying less risk. This is probably what most investors realistically want. In passing, we also note that the fund's shorter term performance has been negative, with year-to-date returns of -7.6%. Is the model broken ? Does it no longer make sense to diversify across multiple asset classes ? Or is it simply that over the shorter term, markets are inherently volatile, and those in instruments like gold doubly so ? We think the latter.

Last week we also had the opportunity to attend Didasko's Practical History of Financial Markets course in London, taught by Andrew Smithers, Stephen Wright, Gordon Pepper, Michael Oliver, Peter Warburton, Herman Brodie and Russell Napier. We can only echo the testimonial of Sebastian Lyon of Troy Asset Management, who described the course as:

"The best and most valuable two days I have spent outside the office in twenty years (holidays excepted). In a field which remains mired in short-termism and brevity of memory, all aspiring and experienced fund managers should attend this course. They will gain the invaluable advantage of historical perspective."

One of the core components of the course is an extensive discussion of CAPE, the 10 year cyclically adjusted p/e ratio, and perhaps one of the very few financial metrics that has predictive value in the context of equity market investing (not in the short term, admittedly, but plausibly over the medium term). Yale's Professor Robert Shiller updates the CAPE ratio from his website and it is shown below:

CAPE ratio for the US stock market (blue) and long-term US interest rates (red)



If you accept that CAPE has some predictive or admonitory value, you should be concerned that the US stock market at its current level of 24x is **significantly above** its long term average, though not as egregiously overpriced as in 1929 or 1999. That alone should be cause for some caution and tempering of the animal spirits. As Russell Napier suggests, any correction from current levels, if it comes, could be within the context of either an inflationary or a deflationary environment. If it is an inflationary one, the decline could well be long drawn out. If it is a deflationary one, the decline could be sudden and precipitous. We have been warned.

Tim Price
Director of Investment
PFP Wealth Management
30th September 2013.

Follow me on twitter: timfprice

Email: tim.price@pfpg.co.uk Homepage: http://www.pfpg.co.uk

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