INVESTMENT REVIEW

We have come to the end of the year with performance flickering either side of breakeven. Despite this, we are breathing a big sigh of relief, and the phrase 'so far, so good' comes to mind. There are problems ahead, and we will need a commensurate amount of good luck to get through it. At the risk of being a rusty CD (one must upgrade one's clichés), Ruffer's investment style is neither favoured by strong markets or weak markets. What we need is to be able always to find investments which will offset one another, **so that we do not then need to be right about the direction of the markets**. We did well in 2008 not because the market was bound to be a stinker, but because if it turned out to be a stinker, we knew what sort of stink it would produce.

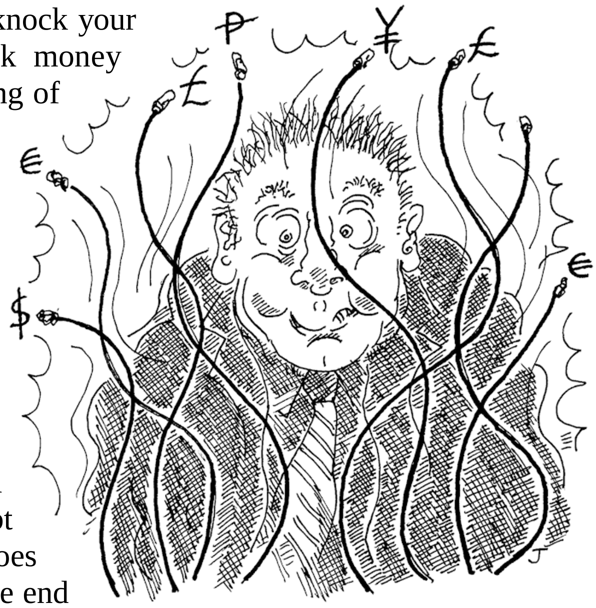
The difficulty today is that *currencies* are having to play a larger role in our offsets, and currencies are subject not only to economic influence, but political interference. An example of this has been the Swiss franc, which we (correctly) identified in 2010 as being a likely beneficiary of trouble down at t'Merkel. We didn't buy it, because we were afraid that their central bank would ambush the speculators. In 2010, the Swiss franc shot up: the Bank of Switzerland intervened in huge size, the Swiss franc hesitated for about 10 minutes and surged higher and higher. Then in August 2011, the Bank acted again in massive size, and the Swiss franc dropped against the US dollar from 1.37 to 1.06. The point is not that calling the Swiss franc is difficult. It is that calling the Swiss franc is impossible, and that removes one letter from the alphabet of investment opportunity. The same is true of the Japanese yen, which is a pity, since back in 2008 these were the very currencies which gave us our protection.

The key to the avoidance of poor performance in 2011 was to have a big weight in the government fixed interest markets: especially in UK gilts. The latter started the year expensive by any previous standards, and investment managers who avoided them were no sillier than those who sold their technology holdings shortly before the dot-com boom got started. As retail price inflation breasted 5½% in Britain, what would the odds have been of War Loan 3½% returning to par (100) in 2011? Well, it didn't quite, but 99.57 isn't far off! Our large holdings of inflation-linked bonds rose sharply in sympathy with their conventional cousins: but if these cousins are in bubble-territory how wise is it to be travelling in the same charabanc with them? Blood may be thicker than water, but it makes more mess on the carpet.

So the biggest danger going into 2012 is our holding of UK and US government index-linked stocks, whose performance in 2011 was the backbone in neutralising a 6.6% fall in the world equity indices. Shouldn't we just sell them, and if the fundamentals are favourable, buy them back when they've dropped back in price? That requires two right decisions, and runs the risk that one gets out, and never gets back in again.

And the fundamentals are sensational, absolutely sensational – every bit as good as buying Amazon and Apple at the top of the TMT boom. (The former has gone up twelvefold since then). We are going into a period when everybody from the Governor of the Bank of England to the Deputy Governor predicts that inflation is going to drop sharply in 2012. They may well be right, but what happens thereafter? At the risk of going over old ground, I will set out why our – your – inflation-linked bonds are uniquely in a position to protect you in 2012 and beyond.

The 2008 credit crunch remains the crucial starting point in this. A dislocation accompanying a massive and comprehensive indebtedness led inexorably to those debts being unrepayable – as always happens at this stage of the cycle. The inevitability of an increasing wave of bad debts beckoned – but Dr Bernanke, supremo of the Federal Reserve, bought in a mass of this debt through government action: quantitative easing. It was a brave move, and was intended to buy time – and it worked: time was indeed bought. The hope, of course, was that in that time, the economy could grow and thereby make the debts smaller in relation to the larger economy (just as a student loan is big to a new graduate, but small to the successful lawyer he becomes in a few years). We described the Bernanke initiative as a 'firelighter' – burning fiercely, but of limited duration. The story of 2011 is that the duration of that firelighter has run out, and subsequent easings have been decreasingly effective: more inflation, less proper growth. Only one barrel of Bernanke is still in place: interest rates so low that they knock your hat off as they fly past. The other barrel – central-bank money available for the system – is shot out. The result is something of a phoney war: the lack of money available for investment will eventually asphyxiate economic activity, but in the meantime, near free interest rates stimulate spending, and make already existing borrowing easy to service. The net effect, short-term, is better than the pessimists fear. But it raises again the 2008 spectre of a world which cannot repay its debts.



This condition was the very essence of deflation in 2008, and its return is no less deflationary today. But 2012 is, crucially, different from 2008 – the debt is increasingly in the form of government debt, and when government debt defaults, it takes the form of inflation, since the currency goes to ruin. And just as with Enron, Worldcom or Ceausescu, the end comes surprisingly suddenly, since it is a failure of confidence in the currency which acts as the trigger. The credit agencies have worked this out already, and can't afford to repeat their mistakes of asset-backed loans going bust with AAA ratings. So France and the other Europeans may have to learn to live with AA ratings during the interim period. When the loss of confidence comes (and we are arrogant enough to believe it is a 'when', not an 'if') a country's citizens will fear that the value of their money is compromised – and they will rush to spend it, thus making a reality of their fear. Every schoolgirl who has studied economics knows that a price level is determined by multiplying together the amount of money in the system ('quantity') by the speed with which it circulates ('velocity'). Economists, being mathematicians, and therefore formula-fanciers, spend all their time measuring the quantum; the next generation of schoolgirls will know much more than their elder sisters about the velocity.

This new inflation could be really exciting, although rather like admiring the pretty pattern of the tracer bullets as they arc towards you. Throughout this period, interest rates will be nailed to the floor. Inflation of 5.5% didn't get them to move ('economy's too brittle, old boy') – the same could well be true with inflation in double-digits. This will tear through investment values, where cash on deposit will lose money in real terms at a similar double-digit rate, and most investments will not match cash. But index-linked are exactly designed for this eventuality. They prosper not so much from high inflation, as high inflation coupled with low interest rates. It's the difference between the two which makes them move, and the long-dated ones can match a soaring Amazon for investment return as the yield-basis changes.

A quick word on my personal plans. I shall cease being full-time at Ruffer on 31 March and after a few weeks return to work here on Mondays, Tuesdays (in the morning) and Fridays. With Henry Maxey, I shall remain responsible for the asset allocation of our assets under management – this partnership has been in place for over five years. And I shall continue to write this quarterly review!

Jonathan Ruffer
January 2012