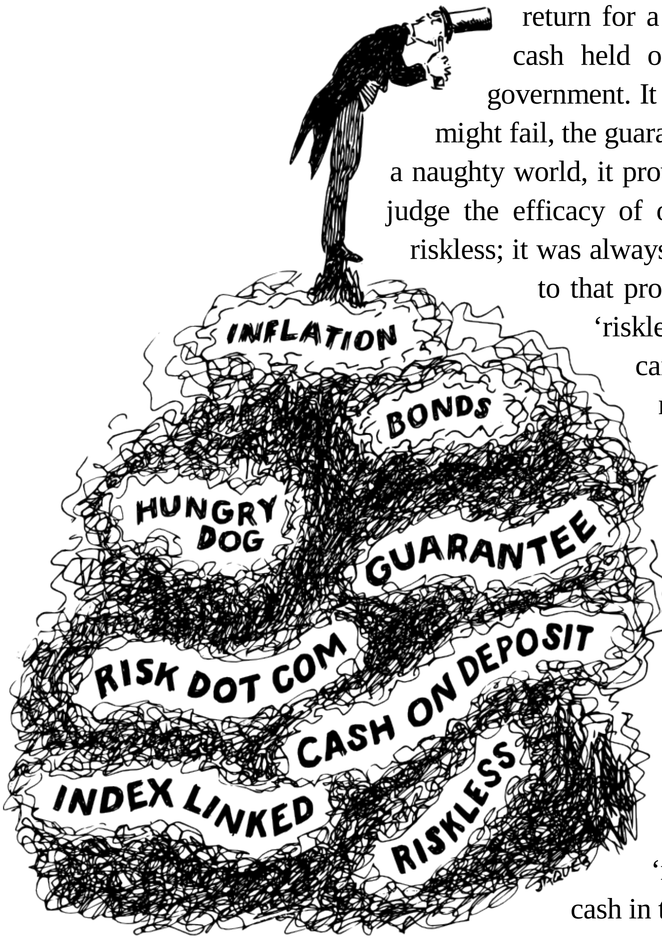
It is usual to take a rather broader look at the world at the year end, and we return to the idea that the resolution of all our borrowing woes will be achieved by the onset of a deeper woe: the partial destruction of our money in the form of inflation.

It is often the small events which are the most interesting to observe. I have a small pension fund with one of the big-name life-companies; every year, end-September, they write telling me what it is worth, and what my annual income might be from it when I am 65. They are charged by law to provide this information, and following the scandal of Equitable Life, the industry gives the most careful consideration to the reasonableness of this income projection. I am invested in their UK government indexed-linked bond fund. The September 2010 value was £87,666 and expected to provide an income of £4,090. Two years later, their letter informs me that the fund is worth £100,840, and an income forecast of £3,330. The capital value has performed excellently, but the income projection, so carefully considered by industry expertise, and constrained by law, has gone in the opposite direction. The reason is to be found in a sharp drop in the expected future return on the fund: down from 7% per year, to 3% – on this asset class. This is explained in the letter as follows: 'The standard FSA growth rate is a middle rate of 7% each year. The rate we've used may be less where the standard rate overstates the investment potential of the fund.' On this basis, if they are right, the cost of providing the income has gone up by over 40% in that period and I shall not receive my money back until I am 98. Their clear message is that it is time to sell the asset-class, and reinvest elsewhere: the lack of any realistic long-term increase in value was the warning sign that the TMT boom and the 1989 Japanese equity markets were bound to destroy value. But are the great and the good (and the lawyers, if different) correct in making this implicit claim? Is the current 'overvaluation' of these assets just another bubble in the roaring foam of man's speculative frenzy?

The answer has to do with risk – or more particularly, risklessness. A riskless investment is not a description of absolute safety but it is a practical attempt to differentiate it from all other assets which might be expected to provide a better return for a greater degree of risk. This quality is generally identified with cash held on deposit in a bank, where that cash is guaranteed by the government. It is not that people cannot see that there are risks: the government might fail, the guarantee might prove weasel, your dog might eat the passbook, but in a naughty world, it provides a benchmark, if not absolute, at least sufficiently robust to judge the efficacy of one's risk assets. No one pretended that dot-com stocks were riskless; it was always accepted that the point of them was to provide a return superior to that provided by riskless investments. But these index-linked gilts have 'riskless' qualities, in that they give protection against inflation which can threaten cash on deposit. For much of the time, when there is no inflation, this will seem an unreal protection from a merely theoretical risk. At other times, such as Britain in the 1970s, this would have seemed the only quality which mattered. Both cash and index-linked have claims to be regarded as riskless, and these two candidates for the title of riskless are giving enormously different signals, whereas one would normally expect assets whose virtue is safety to trade in a similar, and unvolatile, fashion. The inflation-linked bonds have become very expensive against cash on deposit. The question arises: has the current value of the bonds gone up against (riskless) cash, or has the value of cash on deposit gone down against (riskless) bonds? Have the protective qualities of the bonds become more 'real' in people's minds and what does that imply for the status of cash in this new world we are in?



If one looks for a precedent, there is a good one in Germany's Weimar Republic in the early 1920s. It is invidious to bring in periods of hyperinflation when writing about the present situation, since hyperinflation is an expression of national bankruptcy, whereas today, the dynamic is the possibility of an inflationary haircut which reduces the spending power of money by, say, one third over a number of years. To repeat, the chances of the rich nations of the world having valueless currencies anytime soon are nil. Nevertheless, it is instructive to see how people behaved when they were confronted with the destruction, partial or otherwise, of their savings. Why, for instance, did Germans, faced with a devaluing currency, not convert their marks into a strong currency? Many people, of course did so, but there was an obstacle – an obstacle of mind. To convert out of the mark required, at the exchange rates that prevailed, an acceptance of a loss of more than half the spending-power of one's money: the mark was impossibly cheap to sell into another currency. The result was that huge numbers of people planned to make such a switch, but not at the rates ruling. And there were several huge, nonplussing rallies in the mark to show that getting the timing right seemed essential; and so it was that many if not most Germans who had identified how they could protect themselves from danger, failed to do the very thing they longed for. Similarly, most people can see the insurance value of index-linked stocks, but regard them as completely wrongly-priced.

We are comfortable to hold this asset class in the conviction that this will protect us in another apocalyptic move, brought about when the markets no longer allow governments to act as they presently do. It is the most important element by far in the portfolios, and yet it is not a big bet. We do not need this frightening outcome for our portfolios to prosper – we have the rest of the assets to keep things going in the sunshine.

What of the other assets? The key to performance in 2012 was to ignore the cross-currents, the dangers facing a brittle financial world, and to invest on the basis that accommodative monetary behaviour would push asset prices higher – all other things being equal. We go into 2013 with the same dynamic, except that the drumbeat of money-growth is bolder, more wanton, than a year ago. The Federal Reserve, following a policy change in September, no longer waits for evidence of a stuttering economy to press the button. Monetary stimulus is now anticipatory, and the incoming Governor of the Bank of England is set, it seems, on a similar trajectory. It will likely drive asset prices higher – but the dangers which proved expensive to guard against in 2012, are still there. How do we balance these, and obtain advantage in bull or bear conditions?

We hold roughly half of portfolios in equities, in the UK, Europe, US and Asia, but the largest geographic position is in Japan. This market was broadly flat when we last wrote to you, although we had made good money in financial and property stocks. In the last quarter these and other holdings surged further, providing a strong finish to a dull year. The rationale in Japan remains intact; it is the warrant on world economic growth, and so more of the same in terms of monetary stimulus should favour Japan without the rest of the world's downside. The stability of Japan, its lack of overcapacity, and the absence of financial or labour fragilities, give some protection, and afford it the ability to generate a self-sustaining economic recovery. The low expectations built into the possibility of a Japanese economic recovery provide the opportunity for further sharp market rises. The major obstacle to a more bullish backcloth has disappeared with the appointment of Abe as Prime Minister, and the forthcoming retirement of Shirikawa as Governor of the Bank of Japan. In this new world, the investment danger for foreigners is a weak yen (we have been fully hedged), but this is a benefit to the equity market.

Japan is not a one-way bet – the new administration has upset China, where exports are down 8% since relations deteriorated. The last two quarterly GDP figures were awful, a much-feared consumption tax is due to impact in the middle of 2014, and taxes on personal expenditure have often been the prelude to recessions in Japan. Nevertheless we sense that the consensus is changing, and there is an inflection point: a realisation that being a rich country does not ensure that this will be a permanent feature – and that they must fight to regain the initiative in wealth-making. The popular image of their society from the outside is of conservative timidity; anyone who knows its people, from Admiral Rozhestvensky in 1905 onwards, will not fall into that mistake. When Japan reaches out in a new direction, hold on to your hats!

Jonathan Ruffer
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