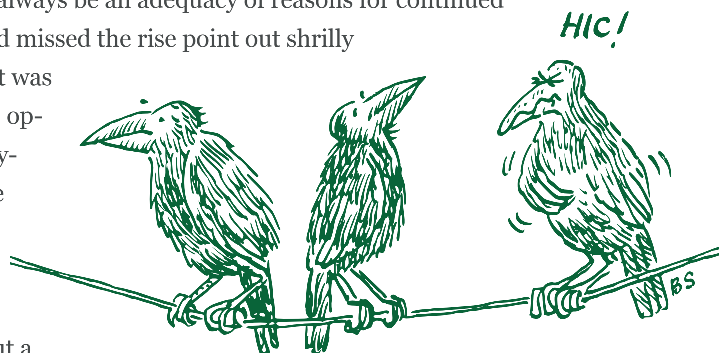
Investment review

RUFFER

Back in the late 1980s, investment strategy seemed to revolve largely around the geographic weightings of equities. It followed the startling stock market moves in the mid-years of that decade, when the European markets awoke out of a deep slumber, and for the first time in 25 years surged upwards. Nobody knew much about the place nor about Japan which was on its way to its stupendous bubble, where the Imperial grounds in Tokyo became worth the same as California. These faraway places, about which we knew so little, mesmerised the market; hence the preoccupation with geographic representation. I came to understand the code, and its most interesting element was the percentage committed to European equities. The higher it was, the more bearish the strategist – the reason was that it was the makeweight: as he sat and sucked his pencil, giving a grudging allocation to a dull outlook in the US, not rating the chances in the UK (another small figure there), he would find himself a long way short of the necessary 100%, with only one area to allot: Europe. A bearish strategist's view of the outlook in Europe in those days was a-sparkle.

This thought came to me when I look at today's market. We have had a bull market which has lasted nine years. As time has passed, it has caused many to consider alternative investment opportunities to the mainstream 'equities 'n' gilts' and it has resulted in the same fallacy as the 'European equities are best' calls of the late 1980s. Private equity transactions are at an all time high, running at $3 trillion per annum. None of us has much of a clue whether $3 trillion is a big number or a not-so-big one (it's big). Then there are the unquoted 'infrastructure' funds which have a highish yield, and the property funds, too. Anomalies can exist in whole asset classes whose main feature is that they do not mark to market – you can't deal at, or necessarily near, the asset value shown. That's what caught out the Triple A mortgage bonds in 2008. In short, it is comfort food – the cake that you can both eat and have: it is for those who cannot bear to leave the party when the band plays on, but are fearful of the music stopping.

I have been on record as saying that this is the most difficult market that I can remember, excepting only the TMT boom in 1999, when 'new economy' stocks soared upwards. Then the impossibility was that stocks one had not the slightest intention of owning went higher and higher. The saving grace was that the boom did not last long. This time the equities and fixed interest stocks which we have not the slightest intention of owning go up, lazily, slowly – but relentlessly. The feature of a boom is that there will always be an adequacy of reasons for continued ownership, until after the event, when those who had missed the rise point out shrilly how clever, really, they had been, and how obvious it was that it would end in tears. Booms are much easier as opportunities to lose money than to make it, since buoyant markets tend to suck the aspirants into the game a fair while after it started, and once in, there's no obvious thought process to leave the winning trade. The pessimists sit like crows on a wet telegraph pole, waiting for the markets to break – but a crow can sit only for so long on the pole without indigestion.



For the long-term investors, rain and shine is best lived through, rather as most ungeared house-dwellers do, hoping that prices are down when they want to upsize, and up when they want to downsize. Market timing is dangerous because human emotions plead with the bank account to do the wrong thing. If I was to make a prediction, it is not that the markets will drop sharply – of course they will, one day, that's what markets do. The value is knowing when, and that's a matter of guesswork. No, the prediction is that, when they do eventually fall precipitately, then many, many investors will plunge back into assets at 'bargain' prices, and, in its retrospect, these repeated sallies into what will have become dangerous assets will be where the real money is lost. The October 1929 crash saw the market recover by April 1930 to levels… which it did not see again until 1954. In 1966, the great equity bull run looked over, but it got back to the same level in the spring of 1972 (and, again, in the September of that year, the week I began as a stockbroker with Myers & Co). In Britain, helped by the red socialist, Anthony Wedgewood Benn, it was to drop by 93% in real terms from there. That will, of course, not happen again unless we get a Corbyn government – at the moment markets clearly do not see this as a risk.

I might conclude these thoughts with an observation. Ruffer LLP is not a crow on a telegraph pole, it aims to provide satisfactory returns over the long term. Since we began, in 1994, this we have done compounding at a compound annual rate of 9.4%. We have tended to do well in market setbacks and in the immediate aftermath, and then comparatively

poorly as the reasons for optimism fade, but markets continue upwards. We describe this phenomenon internally as 'driving the tractor on the motorway', relying on a future onset of moorland to see off the Ferraris and Porsches which have so insolently swept past us earlier. As I say, we do not set out to be bearish, an attitude which leads to a policy of not owning things – we set out to be realists, whose task is to find things in which we can invest. Every investment has risk, so the man who keeps his head below the parapet keeps himself safe, but leaves clients exposed to a barren wasteland of opportunities missed.

Investing for diversity

What do we see, and how are we invested for it? The dominant present force is the distortion in the price of money – it yields nothing, and this means that all assets are overpriced, since all assets are priced against the return on cash. For the conservative investor, it also means that the more stable the investment opportunity, the more influenced its valuation will be by the yield on cash, which is off-the-scale expensive. We are therefore in the topsy-turvy world that the more inherently safe an investment is – a promise from HM government to pay interest and give your capital back in a year's time, say – the more risky it is, because it is wrongly priced, and its very stability allows for no pleasant surprises in the actuality of the outcome. Perversely, the safest valuations are found in out-and-out speculations, since they have little correlation with the price of cash – but who wants to build a portfolio of hairy monsters? We certainly don't! But it means the staples in the equity market, exemplified by the tobacco and food companies, are not for us.

We have a lowish, but still significant equity exposure: around 40%. It has three main emphases. It is geographically balanced towards Japan (especially its banks which are incredibly cheap, but more on that in a moment). It is full of special situations, across the major economies, reflecting our strong research capability in-house. It has a strong showing in the financial sector: banks and insurance companies. In the event of a dislocative fall in the markets, these would not do well, but there is a possibility that after ten years of anaemia, the world sees a burst of coordinated real growth, without, for the moment, any inflation. The financials are not priced for this at all, and could be expected to be very strong. Their virtue will be to protect the portfolios from assets which would fall in this eventuality.

We have no – or virtually no – exposure to conventional fixed interest markets. This is where the epicentre of the danger lies. We have a bit in gold, and a lot in inflation-linked bonds, mostly in the UK. In percentage terms, most of that is in short-dated stock, which is designed to be stable, but to provide a useful 'extra' if our long and strongly-held view that there will be inflation comes about. But the heart of the portfolios is in the ultra-long linkers, which are extremely price-sensitive to the yield environment. We could see extreme circumstances where they lose the majority of their value (circumstances which would drive the financials up by an equivalent amount), or multiply by around 30 times (the Wedgie world).

Our philosophy is to examine all the possible outcomes and have as many 'plays' on different outcomes as possible. Only occasionally do we leave any significant asset unprotected in the portfolios – the financials are there in size to protect us from being 'wrong' on the inflation call. I put the 'wrong' in inverted commas, because it is perfectly possible that it will be the onset of deep deflationary conditions which causes governments and central banks to do those things that hasten a long period of high inflation.

Our biggest fear – and our expectation – is that in a major setback, all asset classes fall in value. Historically, our protection in difficult times has been a diversity of assets. If equities and conventional fixed interest fell heavily together, would we be protected? This investment review casts a jaundiced view over the 'cake and eat it' diversification. Yet without proper diversification we will not be well off, and many people are invested at Ruffer to keep them safe through thick and thin. It will be no defence to say that we were too thick to have contemplated how universally 'thick and thin' might need to be interpreted. So, we too have our diversifications for this scenario. They are all ways to make money out of difficult market conditions: we accept that we might turn out to have rusty sabres against the blitzkrieg of severe markets, but we believe that they will do the trick, as they did in the 2000-2002, and 2008-2009 periods. They centre on three observations. In blizzards, market volatility increases. In typhoons, credit spreads widen. In hurricanes, the yield curve steepens. Nine years of rising markets suggest to some that "urricanes 'ardly ever 'appen'. To quote the maiden who said this, we've moved our 'bloomin' arse' and made sure the appropriate protections are in place.

Jonathan Ruffer, October 2017

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