

Investment review



The performance of the portfolios remains becalmed, but it is the unseen currents in the water which will prove more important in vindicating (or otherwise) the stance that we are taking. If there's a single message, it's one of reassurance. If the markets are benign from here, then we believe that we'll make good money. If/(when?) there is a long-awaited setback, we think that the portfolios are well protected. If the subsequent landscape is arid and unrecognisable, we have, crucially, preserved flexibility. This last point is an important one. It is no good having the only hotel left standing in a battle zone, if the last visitor has gone for good. To achieve all these things, we have to survive (and thrive) through three phases: the first phase is more of the same, the second is dislocation; the third its aftermath.

Today (the first phase) around 40% of the portfolios is committed to equities: about 'middle-range' in the last few years. They are emphatically not defensive. They are concentrated in those sectors which have not performed well (as sectors): the cyclicals, the financials, and natural resource stocks, along with a range of one-off companies bought for specific performance. Whilst it is true that the growth stocks have stolen the show in terms of investment performance, it has not been the only place to be, and the stock picking of our 30-strong research team has proved this. We are positioned in the areas where strong economic growth should flow through to companies whose business models are robust. We are comfortable with this position; if we thought that the stock markets had nothing to offer, we'd have minimal investments there: these investments will, of course, go down if the market breaks, but there is other stuff to protect the portfolios from that. The key is that this asset class could make a double-digit return if the sun stays out.

So much for the first phase; we remain of the view that these markets will at some point become dislocative, and when they do, the downward pressure will be instantaneous: having the characteristic of 1987 ('where did that come from?') rather than the dynamic of the rotten birthday party, where things go from bad to worse as the evening progresses. We do not (cannot possibly) have a set view as to what damage a comprehensive fall (essentially, of all asset classes, although those assets which are not subject to objective pricing might appear unscathed) might do. We approach this the other way round. If the markets fall 30%, could our portfolios withstand it? If they fell 50%, could our portfolios withstand it?

We aim to produce a portfolio which breaks-even in these two scenarios, even though there will be few asset classes which will protect us. Our approach has been to invest small sums of money into powerful instruments (options and credit default swaps), which have the capacity to make very large sums of money in extremis, but which, until then, (again and again) will expire worthless. This has cost the portfolios around 2% per annum in the last few years – we emphasise that this is not a routine; it is a temporary response to the combination of asset prices being too high and interest rates too low. Our primary role is to ensure that we do not preside over a permanent destruction of a significant part of clients' wealth. Twice this century we have seen asset prices halve (2000-2002, 2008-2009), and although on each occasion they bounced back again, these quick recoveries were the exception, not the rule. The 1929 level of Wall Street was not reached again until 1954.

There is one class of investment which falls outside the ring-fence of 'breakeven' on performance during such a crisis. That is our holding of long-dated UK index-linked stock, which represents something a little over 10% of the portfolios. The reason for this is that their price is extremely sensitive to changes in the level of real interest rates. In the maelstrom of dislocative markets, it is a bold statement to assert

that this volatile asset class will be immune from sharp losses. We are nevertheless reluctant to reduce these holdings, because they represent a near-perfect vehicle to protect clients against low interest rates which (after tax) fall well short of compensating the holders from the losses caused by a future inflation. There is a chance that they will do well from the outset of market trouble. If we've sold with a view to buying back more cheaply, we will have lost this protection.

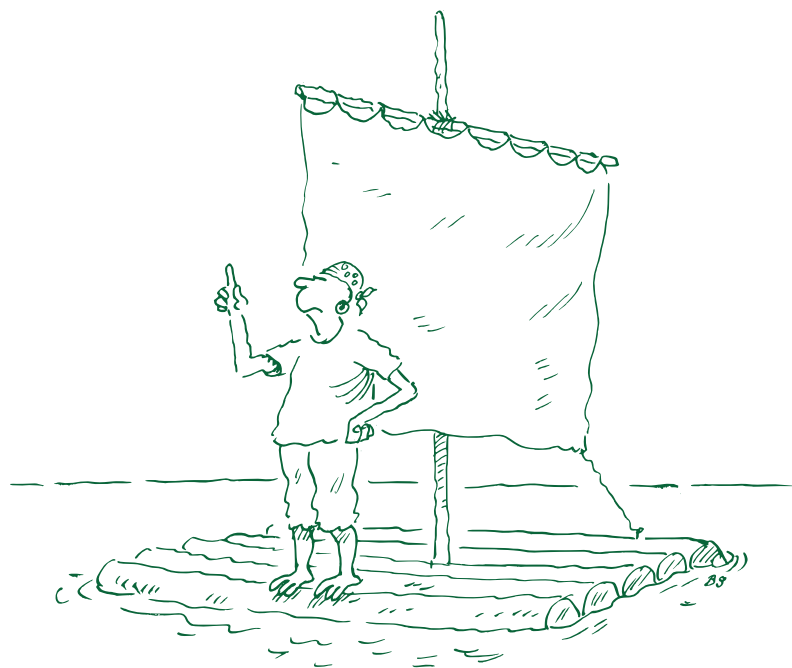
What of the aftermath of a sudden step-change in the market? The biggest danger in this third phase is the inflexibility which comes from the difficulty of trading out of positions which no longer look appropriate. One is reminded of the opening sentence of a recent Financial Times article (allegedly from an estate agent in English-speaking Dordogne, post Brexit, to aspirant sellers): 'Take the value of your house. Halve it. That's the price you can't sell it for'. These are the moments where cash is the engine of portfolios, since it is available immediately to reshape the assets. If portfolios have cash in this third phase of the market, there will be real opportunities for bargains, but only to those whose spending power remains intact. It is a generation since we have seen the malaise of untradeability in primary Western markets, although in the peripheries it is a constant factor. It may well be especially severe in the unquoted sectors, in private equity and venture capital, where valuations, always ultimately assertions, prove to be an unreliable guide to realisation prospects.

This is the road map we are working with. My own observation of investment road maps is that they are neck-and-neck with communist five year plans for insight and effectiveness. Yet without them, it is impossible to create an effective investment strategy. This articulation should provide reassurance to those who are nonplussed or irritated at our failure to make money in the last 18 months. It is intended to address the universal question asked of travel guides,

politicians, playwrights and shaggy-dog storytellers: 'where's all this leading?' If I could put in a personal note here: I sometimes say that if I was a wild animal, I would be a gazelle; I have a highly developed sense of danger, and, usually, but not always, the agility to escape it. This means that danger is spotted early; it also means that long periods of time can elapse before the storm breaks. If the progression of events were static, these 'long periods of time' would make for nervousness. But time

is a continuum. The 2008 crisis centred on the excessive amount of debt which was manifestly represented by dud collateral. World debt got to 280% of world GDP (the totality of its economic activity). That debt has changed shape over the last 10 years, but it hasn't gone away. It is now 320% and

is still, relentlessly, rising. Why then aren't we all terrified? The incidence of debt is somewhat akin to the manic-depressive. When it's 'good', it makes economies grow, and if readily available at next to no cost, then it makes asset prices go up. Market sentiment is made by market investors; we are in the manic phase. Was I alone to smile when Mark Carney, Governor of the Bank of England, said that a hard Brexit would cause a housing crash? It did not seem to occur to him that this assertion, if true, forms an unanswerable argument for engineering a hard Brexit. We badly need house prices to be lower. Yet he's right that buoyant asset prices are the lynchpin, presently, of economic confidence. Take that away, and the knock on effect to the



real economy will be severe, as it was in 2008, and in 1929. The Wall Street Crash was the pivot when the can-do of the 1920s in America turned into the can't do of the 1930s.

I started my working life as a stockbroker in 1972 (in the week when the market flirted with its all-time high achieved in May of that year). In real terms, the next seven years saw the market drop by 93%, before starting a bull market which has been going for 40 years. Those who learned their lesson in that period are largely dead or superannuated. Since 1987, the central authorities have been putting the highest priority on smoothing market performance, medicating the whoopsies: the 1987 crash was the first one which 'enjoyed' this privilege, and since then 'buy', and 'buy the dips' have been the watchwords of successful investment. You have to be over the age of 60 to have learnt any other lesson which has been as effective as those two. Old dog? Gazelle? Whatever the metaphor, we are busting a gut to keep you safe.

Jonathan Ruffer

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