Ruffer Investment Company

RICA is an all-weather proposition, aiming to deliver over a range of market and economic outcomes...

Update
12 May 2021

Summary

Ruffer Investment Company (RICA) is focused on preserving and growing real (i.e. inflation-adjusted) capital and the managers seek to ensure that the trust consistently generates positive returns, avoiding sustained losses over rolling 12-month periods. RICA offers a differentiated alternative for investors looking for equity-like returns with lower volatility and who seek to increase the diversification of their assets.

The managers, Hamish Baillie and Duncan MacInnes, have long propounded their view that elevated debt ratios and too little economic growth have created a vicious cycle whereby stimulative support and intervention from governments and central banks is required in ever-increasing doses, ultimately leading to an environment of structurally higher inflation. As we discuss under **portfolio**, they believe that recent policy moves have increased the probability of structurally higher inflation.

Nonetheless, RICA is constructed with the aim of generating positive returns irrespective of market conditions. Accordingly, RICA continues to incorporate hedging strategies not typically seen in many investment products readily available to the retail investor. These include exposure to assets such as credit default swaps, which offer asymmetrically high upside in adverse economic scenarios with limited downside. Other examples include payer swaptions, volatility strategies or, more recently, Bitcoin. As discussed under **performance**, these have often proved supportive in more volatile environments.

RICA's board has been issuing shares at a premium to net asset value in recent months to grow the trust, as discussed under **discount**. The object is to increase net asset value and liquidity in the shares while reducing the ongoing charge ratio (OCR).

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Analyst's View

RICA ticks a couple of boxes for us. First, we appreciate the attempt to incorporate investments with potentially asymmetric payoffs into a robust structure and believe RICA seems positioned to generate gains as well as mitigate portfolio downside. Secondly, incorporating RICA into a more generalised equity portfolio has historically dampened portfolio volatility significantly and thereby provided a measure of overall asset diversification. In essence, we would argue this is a retail-friendly product with a coherent and transparent portfolio proving a hedge-fund-like return profile on less than half the fees of the average hedge-fund.

The 'best-case' scenario for the portfolio's relative returns, in our view, would be a backdrop of structurally higher inflation. Yet we take comfort from the continued presence of deflationary hedges. Should disinflation persist, this may well be a headwind to absolute returns but there are portfolio positions that will benefit the fund. We show under **performance** that RICA has positive sensitivity to 'tails' of markedly higher and lower shifts in inflation expectations and think the portfolio structure in place should ensure this remains the case.

BULL
Long track record of making money in both up and down markets
Potential for substantial upside in an inflationary upswing
A diversifier to traditional portfolios

BEAR
Return of a disinflationary environment would likely be a headwind to returns
Dividend yield likely to remain low
Diversified nature means RICA is unlikely to keep pace with risk assets in a strong market rally

Portfolio

RICA is managed by Hamish Baillie and Duncan MacInnes, who, in line with the wider house approach, focus on absolute nominal and real rather than market-relative returns. Akin to the Hippocratic 'First, do no harm' principle, the main priority for the managers of RICA is to avoid losing money.

RICA has a stated benchmark return which is twice Bank Rate. This may not seem much of a hurdle in today's environment, where interest rates are being held below the rate of inflation. However, when RICA was launched, and throughout the last century until a decade ago, the average return on risk-free cash exceeded the rate of consumer price inflation by approximately 1%. A long-term benchmark of twice Bank Rate, therefore, implies the objective of a positive inflation-adjusted return achieved with a low risk to capital.

A top-down asset allocation is combined with a thematic framework designed to ensure the portfolio can generate positive returns in all market conditions. This thematic framework is ever more important in the current market and macroeconomic conditions.

Hamish and Duncan invest across multiple asset classes, operating an asset allocation policy they characterise as the "three legs of the stool". Conceptually, the idea is to ensure that the portfolio is resilient to the prevailing macroeconomic and market environment, yet is able to preserve and grow the 'real' value of shareholders' assets.

Current Portfolio

This first leg of the portfolio stool, and the largest element, is inflation-linked securities which are designed to protect against a period of extended financial repression – interest rates held below the rate of inflation.

The second leg is equities which should benefit from a continued improvement of economic growth post-pandemic. The general tilt of the equity book is towards shorter duration equities (i.e. a general leaning towards value and away from quality compounders or growth). However, a return to the disinflationary backdrop and continuation of a disinflationary environment would still be likely to be supportive of most risk assets. Meanwhile, returns from the sizeable allocation to Japanese equities will, in their view, be driven by value and improving corporate governance identified through Ruffer's **ESG** analysis.

A third leg seeks to protect against any outright economic contraction or a financial markets sell-off. Holdings in assets such as credit default swaps are expected to support the portfolio. The managers note that credit spreads remain extremely low in the US high yield market, despite the huge volumes of debt outstanding and the challenging macroeconomic backdrop. They attribute this to central bank intervention and policy support. This interference in the price mechanism of the market gives the managers the opportunity to buy risk protection at distortedly cheap prices. In the past, Ruffer have been creative in their use of options to achieve downside protection using instruments such as VIX calls, S&P 500 puts, AUD puts and JPY calls depending on the outlook and pricing at the time. Similarly, cash itself can offer some protection in a deflationary environment.

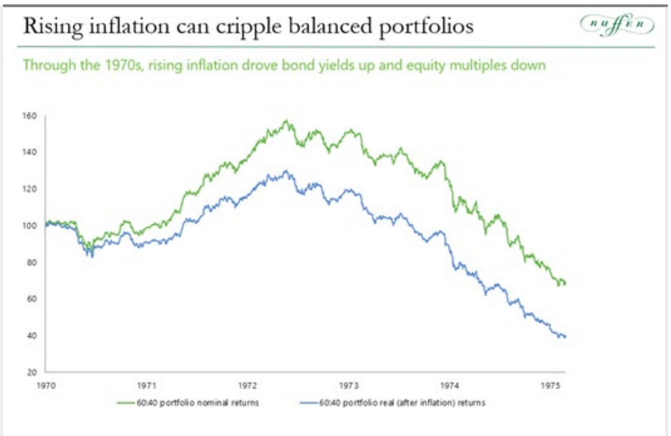
As a house, Ruffer has for a while believed that the end game to massive debt overhangs and stimulus measures across the world will be a sustained period of higher inflation. They note that monetary and fiscal policy co-ordination injects money directly into the economy by putting it straight into the hands of people who will spend it. US stimulus plans are huge, and governments across the world are incentivised to run policy 'hot' for an extended period. Ruffer believe that governments will continue to be supported by the central banks. This will include implicit or explicit intervention in the bond markets to put a ceiling on any rise in nominal bond yield, which will deepen the environment of financial repression.

Meanwhile, during Covid-19, savings rates have risen sharply across the Western world. As economies reopen, the managers expect a surge in pent-up demand to drive rapid acceleration in consumer spending, further fuelling inflationary pressures.

After an extended cycle of declining interest rates and bond yields, where long-duration assets have enjoyed a continuous tailwind, Hamish and Duncan believe we face a reversal and a fundamental shift into a new economic and market regime. For traditional multi-asset investors, this would cause problems as most assets are not priced to deliver real (i.e. inflation-adjusted) returns if inflation levels rise: cash will depreciate in real terms; bonds and prime properties globally offer scant levels of yield relative to the capital risk; infrastructure projects are highly vulnerable to any rise in rates or changes in government policy. Even blue-chip equities on high valuations, they note, are unlikely to provide much protection given their duration and exposure to passive investment vehicles which are vulnerable to investor withdrawals.

The managers note that the last period of runaway inflation in the UK (the 1970s) saw bond yields rise and equities de-rated so both capital values fell. The standard portfolio protection at that time, when there were many fewer alternative investment options, comprised bonds and cash combined with equities and an element of gold. However, whilst a 60/40 equity/bond ratio had long been the asset allocation of a conventional diversified portfolio, even that suffered in both nominal and real terms.

Fig.1: Rica: Real And Nominal Returns On A 60/40 Portfolio 1970-75

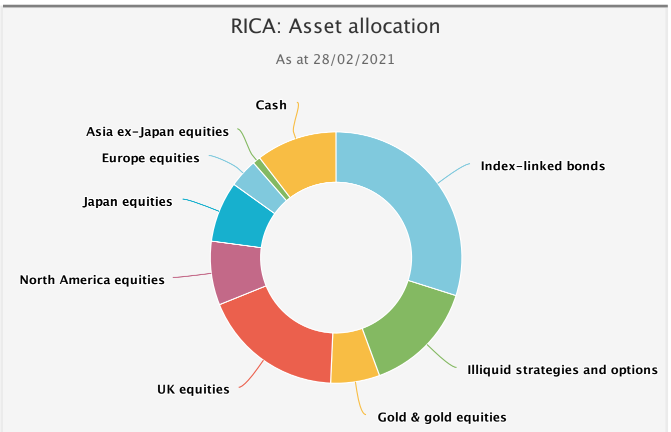


Source: Ruffer

Past performance is not a reliable guide to future returns

RICA today offers exposure to a variety of traditional and non-traditional asset classes and strategies, many of which, including index-linked government bonds, did not exist in the 1970s. The more esoteric assets and strategies are hard to access for retail investors and include convex and asymmetric protective strategies, Bitcoin (which has added significant value to the portfolio, though the position has now been substantially reduced), gold and gold shares and short positions on corporate credit. The managers believe that Bitcoin and gold both have scarcity value in a world of fiat currency abundance, whilst index-linked bonds will deliver improving returns if real (inflation-adjusted) yields continue to decline.

Fig.2: Rica: Asset Class Allocation



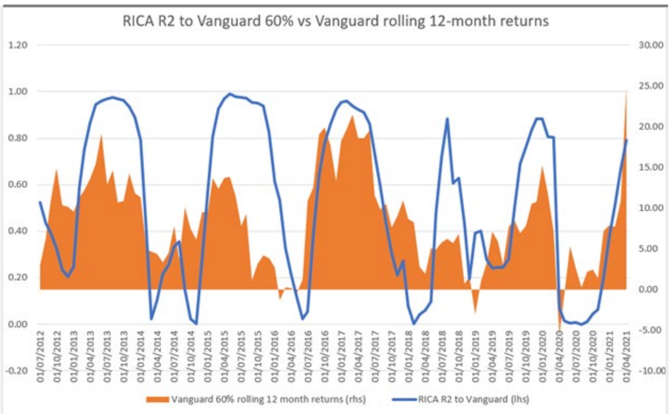
Source: Ruffer

Diversification

The aim of RICA's portfolio construction is not simply to remove all correlation to traditional equity markets but to ensure that the portfolio is robust when other diversification models, such as the traditional balanced fund's 60/40 equity/bond allocation, cease to work (such as when equity and bond markets are positively correlated). Hamish and Duncan are keen to harness market returns from equities and bonds within RICA but also to ensure that as conditions deteriorate there are sources of differentiated returns within the portfolio, which offer sufficient asymmetric positive returns to offset market drawdowns.

This is shown in the chart below where the rolling 12-month returns from RICA are compared with those from the Vanguard LifeStrategy Fund, which is used here as a proxy for a traditional 60/40 equity/bond portfolio. As the chart shows, during periods where we have seen stronger positive returns for the 60/40 portfolios (orange line) the Ruffer correlation to these assets (Blue line) has tended to be reasonably high, showing that RICA is capturing most of those positive returns. When 60/40 portfolios have struggled, RICA's correlation has typically fallen sharply, sometimes to zero. So, having participated in the upside, RICA has de-coupled from the 60/40 portfolio on the downside demonstrating the diversification benefit which RICA brings compared to a more traditional portfolio.

Fig.3: Rica R2 To Vanguard 60% Vs Vanguard Rolling 12-Month Returns



Source: Morningstar

Past performance is not a reliable guide to future returns

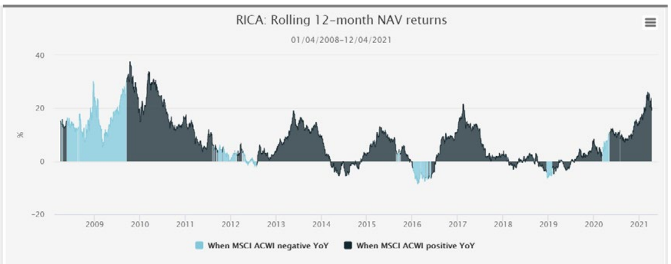
Gearing

Although the board and managers of RICA have the ability to introduce gearing, we understand that this will not be exercised in practice. Both management and the board believe gearing would run contrary to their aim of capital protection.

Performance

RICA's managers invest with the aim of constructing a portfolio that can generate absolute positive returns in all market conditions over a rolling 12-month period – an 'all weather' portfolio. Over the periods where we have daily data (from 31/03/2007 to 12/04/2020), RICA has generated positive NAV total returns on c. 82% of the subsequent 12-month periods.

Fig.4: Rica: Rolling 12-Month NAV Performance



Source: Morningstar

Past performance is not a reliable guide to future returns

As we can see above, the past 12 months to 12/04/2021 have proven to be a strong period for absolute returns for RICA, with NAV and share price total returns of c. 19.2% and c. 26.9%, respectively. Returns have largely been boosted by RICA's equities exposure, though tactical moves to reduce duration have also proven beneficial as nominal yields rise. Bitcoin, introduced to the portfolio in November, has also boosted returns since its introduction. Index-linked bonds, however, have detracted but we would note this is in line with the management aims of the trust, to have different elements drive positive returns at different times. In Q1 2020, it was largely credit protection and equity protection that contributed positively, before reversing as risk markets recovered when RICA benefited from its risk assets.

These 12-month figures are skewed slightly by the timeframe which begins shortly after equity markets troughed in late March 2020. Over the same period, the Royal London FTSE All-Share ETF, a benchmark for the market, returned c. 27.2%, yet to compare solely to equities would not be a like-for-like comparison. It is important to note that over Q1 2020 when the MSCI ACWI was down c. 19.1% the RIC NAV was essentially flat supporting the managers' long-term record of not only preserving but enhancing capital through bear markets.

In terms of risk management, since the start of 2020, RICA's NAV has suffered a maximum drawdown of 3.5%. Over this same period, the FTSE All-Share (as represented by the Royal London ETF) has seen a drawdown of c. 36.2%, and a more 'traditional' equity-bond portfolio, the Vanguard LifeStrategy 60% Equity fund, has suffered a drawdown of c. 17.8%.

Relative to comparable trusts

We note that RICA is commonly compared to a particular group of investment trusts such as Personal Assets Trust (PNL), Capital Gearing Trust (CGT), and RIT Capital (RCP). The Ruffer mandate typically offers more unconventional protection than PNL or CGT. Those two competitors use more conventional asset classes as protective assets rather than 'unconventional' protective strategies such as credit default swaps (though both trusts retain sizeable allocations to index-linked bonds).

Ruffer believe that unconventional assets can play a vital role in asset strategy. Having as wide a mandate as possible to 'go-anywhere' will, they believe, leave them better equipped to deal with the environment they currently foresee of increasing inflation and both economic and market volatility. RCP, as we noted in **our recent update**, has less of an 'absolute return' mandate, and represents more of a diversified multi-asset fund looking to produce lower beta market returns but with a greater acceptance of ongoing market risk and volatility.

There are similarities between RICA and BH Macro in their risk/return characteristics, but the structure of the trusts is rather different. BHMG is a combined portfolio of various trading books with specific risk allocations as opposed to a centrally directed portfolio.

In the table below, we have looked at the median R2 (a measure of correlation?) of RICA to the Vanguard Life Strategy 60% Equity fund on a rolling 12-month basis over the previous five years. We can see that RICA has, on average, displayed a significantly lower correlation to a generic 60/40 strategy than those trusts it is usually compared with, other than BHMG.

With PNL and CGT having not dissimilar weightings to index-linked bonds to RICA over much of this period, we would suggest that the nature of equity exposure within the various trusts (RICA generally having lower duration equity exposure in recent years) and the use of other unconventional defensive assets has proven an important differentiator for RICA, and investors might reasonably expect this to continue in future.

Rica Nav: Median R2 To Vanguard Lifestrategy 60% Equity Fund Compared To Peers

TRUST	MEDIAN R2 TO VANGUARD 60% EQUITY FUND
RICA	0.36
BHMG	0.20
CGT	0.65
PNL	0.67
RCP	0.69

Source: Morningstar, Kepler calculations, from 01/04/2016-01/04/2021

Past performance is not a reliable guide to future returns

The table below shows longer-term measurements of risk management (and risk-adjusted returns) relative to the FTSE All-Share, some comparable peers, and the Blackrock 60/40 Target Allocation Fund. The Vanguard fund lacks a sufficient track record to cover the entire period, so we use the Blackrock fund as the best available proxy even though it does not maintain the target weighting rigidly and incorporates active strategies.

Rica Nav Total Return: Max Drawdown, Average 12-Month Volatility, And Longest Time To Make A New High Vs Peers

TRUST/ INDEX/FUND	MAX DRAWDOWN (%)	ANNUALISED VOLATILITY (%)	LONGEST PERIOD WITHOUT MAKING A NEW HIGH (DAYS)
RICA	-11.8	6.5	595
BHMG	-11.3	5.7	1833
CGT	-10.4	7.7	545
PNL	-24.6	9.0	793
RCP	-25.1	9.3	898
Blackrock 60/40	-24.8	13.4	642

Source: Morningstar, Financial Express analytics, Kepler calculations, from 31/03/2007-01/04/2021

Weekly NAV used for drawdown figures, some NAV figures are Morningstar estimates when reported monthly

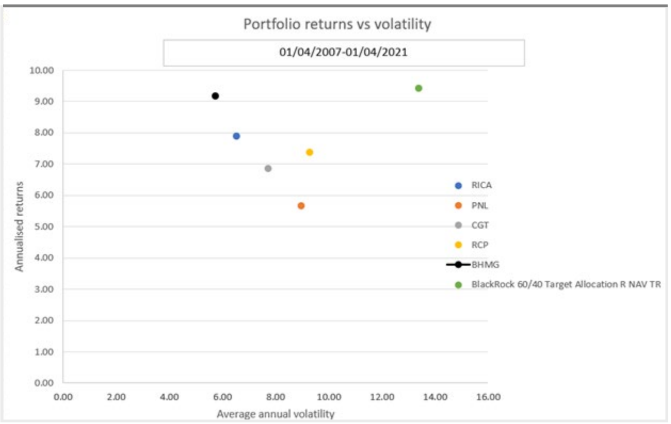
Past performance is not a reliable guide to future returns

Over the previous five years to 09/04/2021, RICA has generated positive NAV and share price total returns of c. 66.7% and 63.6%. These have lagged broader equity market returns, with the Royal London UK All Share ETF returning c. 89.3% over this same period, however, for the most part, this has been a period characterised by a sustained bullish environment for 'long-duration' assets including equities. RICA's risk-seeking book during this period has tended to be shorter duration than those of more conventional peers, which will have for the most part been a headwind to performance.

For many investors, RICA's ability to generate strong positive returns in adverse environments may prove a potent source of resilient capital which can be rebalanced into adversely affected risk assets. In the chart below, we show the annualised rolling 12-month rolling return and annualised volatility of RICA against those trusts to which RICA is typically compared, from 01/04/2007 – 01/04/2021.

We also show the Blackrock 60/40 Target Allocation fund. This is, of course, a period which encapsulates two historically deep market drawdowns and a myriad of other market corrections. We would agree with the managers of RICA that the market environment is likely to be no less volatile in future.

Fig.5: Rica: Average Returns Vs Volatility



Source: Morningstar, Kepler calculations

Past performance is not a reliable guide to future returns

Through the use of unconventional protective strategies, RICA has historically protected against market volatility. We have **previously highlighted** the impact of heightened and dampened volatility in equity markets (as measured by the VIX index) on RICA's returns relative to CGT, PNL and RCP. In a nutshell, in the worst of market environments, Ruffer offers the most protection. And avoiding downside compounds higher returns in the long term. This, in our view, reflects the greater use of protections where payoffs are only likely to occur in periods of heightened volatility.

Rica: Rolling Three-Month Nav Returns 31/06/2007-11/11/2020 In Periods Of Heightened And Dampened Vix

	RICA NAV ABSOLUTE	RICA NAV RELATIVE FTSE ALL-SHARE	RICA NAV RELATIVE TO AVERAGE OF CGT, PNL AND RCP
Heightened volatility	3.2%	11.4%	4.1%
Dampened volatility	1.7%	-0.7%	-0.3%

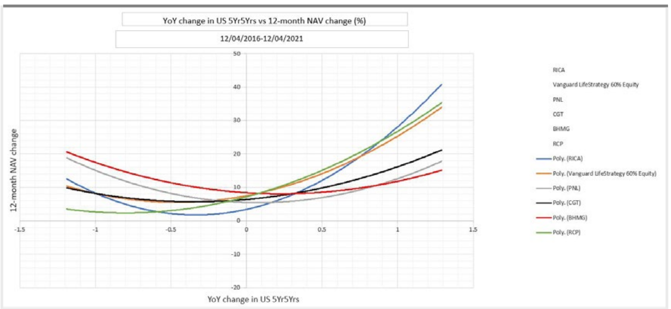
Source: Morningstar

RICA's objective is to achieve positive returns in real as well as nominal terms. Below, we show the relationship between changes in inflation expectations and the NAV returns of RICA, the peer group (BHMG, CGT, PNL, RCP), and the Vanguard LifeStrategy 60% Equity fund.

The X-axis shows an increase in inflation expectations to the right and vice versa to the left. The Y-axis shows NAV total over the previous 12 months. This shows a line of best fit across the underlying scatter points.

We note with interest that the curve for RICA (blue line) starts to rise relatively **sharply at both extremes**, a product, we think, of the unconventional protective strategies kicking in. RICA appears to have typically offered a superior payoff, relative to peers, to rising inflation and protection against deflationary lurches.

Fig.6: Rica: Year-On-Year Change In US 5Yr5yrs Vs 12-Month Nav Total Returns



Source: Morningstar, St Louis Federal Reserve

Past performance is not a reliable guide to future returns

Dividend

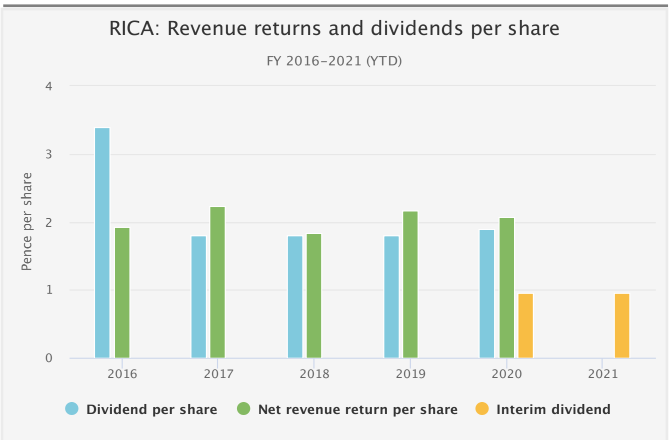
RICA currently yields c. 0.7% on a historical basis (as at 12/04/2021). Dividends are paid twice a year. The trust is designed to focus on generating total returns, without a specific income mandate or target as a matter of policy. This best affords the managers the flexibility to pursue their primary objective of positive total returns in all market conditions.

There will at times be assets in RICA's portfolio which generate income as well as gain. For example, RICA's Japanese equities' portfolio provides reasonable yields from sustainable dividends derived from earnings on which there is a low pay-out ratio. Improving corporate governance is driving higher pay-out ratios but the resulting flow of distributions from these investments by RICA is largely a by-product of the investment process as opposed to a target.

By contrast, many of the protective strategies within RICA will have an associated negative carry which can hold back returns in benign markets. This weighs upon distributable income, as does the recognition of 100% of expenses (excluding the management fee) against income only. This is a more conservative approach than most investment trusts which allocate part of their expenses against capital and part against income.

The board has expressed a reluctance to draw on capital to fund dividends, citing the 'capital preservation in real terms' mandate of the trust. Nonetheless, they have recourse to revenue reserves which, at the last interim review period (31/12/2020), amounted to c. 2.06p per share against an FY 2020 full-year dividend of 1.9p per share (i.e. revenue reserve cover of c. 1.08x). The interim dividend has been maintained against the FY 2020 level.

Fig.7: Rica: Dividend And Revenue Returns Per Share



Source: Ruffer

Past performance is not a reliable guide of future returns

Management

Hamish Baillie and Duncan MacInnes are the named managers on the trust. Hamish joined the team in 2002 and set up the group's Edinburgh office. He works alongside Duncan MacInnes, who joined the team in 2012.

The investment strategy of RICA follows that of the much larger Ruffer business, which was set up by Jonathan Ruffer, who still leads the firm's investment strategy alongside CIO Henry Maxey. The trust has access to prodigious resources, with more than 147 people solely focussed on fund management and research, including 30 analysts.

Discount

RICA shares currently trade on a premium of c. 2% (as at 12/04/2021) to the net asset value. After a period of strong performance, the discount has disappeared and RICA has consistently traded at a premium in recent months, having done so on approximately half of the daily occasions over the previous five years.

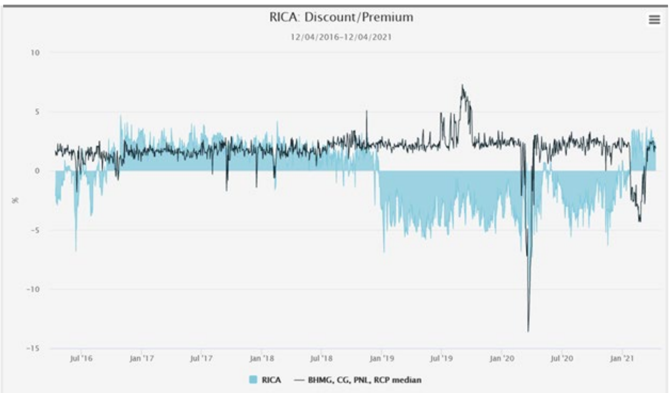
We have previously suggested that a shift to a more inflationary environment may prove a catalyst to the discount narrowing/move to a premium. Ruffers' views on the likelihood that the current environment will prove inflationary are well known and we would suggest that a shift in market sentiment towards an increased expectation of such an outcome might have possibly contributed to increased demand for the shares.

RICA's board has, historically, proven to be fairly active in the issuing of shares to cap any premium in the interests of shareholders who have regular investment programmes. The board has targeted a market capitalisation for RICA of £500m+ to increase liquidity in the shares, reduce the ongoing charge ratio and continue to attract larger wealth managers. We note that one such investment house has continued to add to their position in recent months and now hold over 12% of shares in issue.

With a current market capitalisation of c. £551m, the target has now been achieved, partly through organic growth but also in recent months through share issuance. Thus far in the current financial year (since 01/07/2020) RICA has seen net issuance of c. 11.1m shares at a weighted average premium of c. 1.8%, raising an estimated further £31m for investment. The managers do not anticipate any constraints on their investment process as a result of this growth in assets until much higher levels. As such, issuance in the interest of growing the trust should not be considered a risk to possible style drift.

The board also has the authority to buy back shares if it deems it appropriate. This has not been necessary in recent months, but historically the board has indicated it would begin to consider intervening via buybacks should the discount reach a level of c. 5%. RICA also has a redemption facility, operated through a tender offer, which can be made available each November at the discretion of the directors.

Fig.8: Rica: Discount/Premium Vs Median Of BHMG, CGT, PNL AND RCP



Source: Morningstar

Charges

RICA has an annual management fee of 1% and no performance fee. Its ongoing charges ratio is 1.08%, compared to an AIC Flexible Investment sector average of 1.10% (Source: JPMorgan Cazenove). The Key Information Document Reduction in Yield (KID RIY) figure is 1.46%, compared to a sector average of 2.63%, although we caution that calculation methodologies vary.

ESG

We understand that Ruffer takes the responsibility of stewardship of client capital seriously and that it is closely engaged with environmental, social and governance (ESG) issues, and has a dedicated team for ESG analysis. Ruffer is a founding signatory to the Climate Action 100+ investor initiative and a signatory to the UN-supported Principles for Responsible Investment (PRI). We note that Ruffer's PRI rating has been consistently high in recent years. Currently, they have scores of A+, A, and A on Strategy and Governance, Listed Equity -Incorporation, and Listed Equity - Active Ownership, respectively.

Ruffer vote on every resolution for all voting shares held within RICA, as a matter of policy in the interests of good corporate governance through active ownership. Engagement with company management teams is considered important in their analysis of investments. RICA's approach to ESG is not an exclusionary policy that systematically filters out companies in particular industries. Instead, the emphasis is upon improvement in standards, which are achievable and where such improvements are likely to be accretive to shareholder value. The sizeable exposure to Japanese equities, with the systematic attempts in that market to reform and improve corporate governance standards, are emblematic of this.

While some of the equity holdings may not fall within particularly stringent subjective ESG criteria for some investors, the managers note that by holding shares in these companies, RICA can influence behaviour more effectively through the exercising of voting rights than by selling the shares, which is a last resort. For most investors, we would suggest that RICA will likely meet their ESG criteria.

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