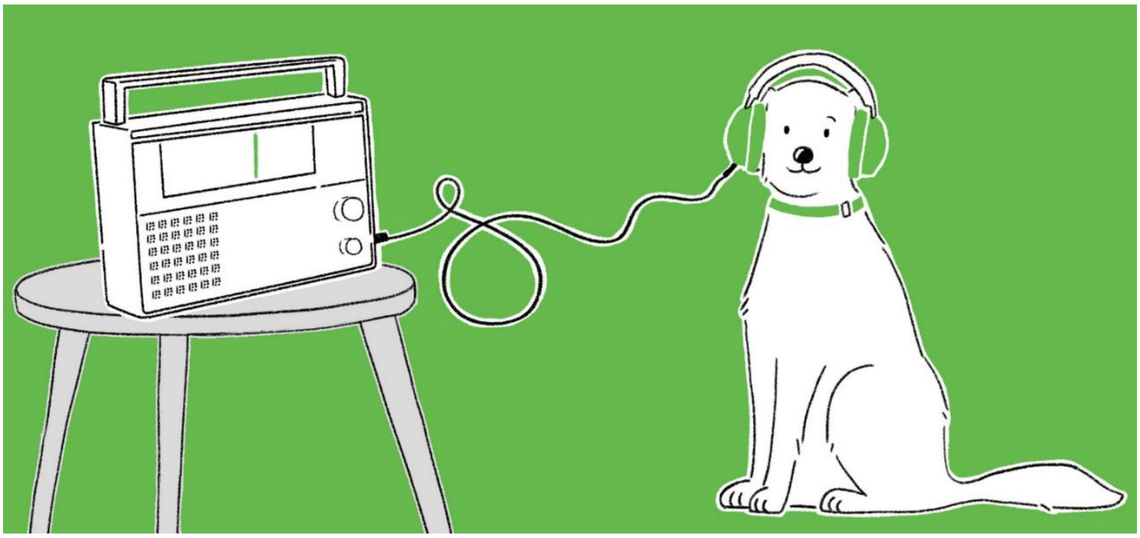
Ruffer Radio

Episode 14 – Ruffer round up – Q3 2022



First published at ruffer.co.uk/rufferradio, 10 October 2022

Rory McIvor

Welcome to Ruffer Radio, a series of podcasts in which we explore the investment universe and share our interpretation of what's going on. We're now into the rusty days of early autumn and with them, we have officially bid farewell to wedding season for yet another year. Usually when sitting down to a wedding dinner, it isn't long before I'm asked, "What do you do for a living?" And I always say, "Investment management," with genuine and sincere enthusiasm. Granted it's not the most novel profession and it's definitely not professional bungee jumper, astronaut, west end actor or moral philosopher, I have to say, it's only the most gracious of fellow guests that manage to mask their disappointment.

But last Saturday was different. I was bombarded with questions about valuations, rising inflation, interest rates and monetary policy. Because, you see, investment over the past few months has become fast and furious and fascinating, and everyone is trying to make sense of the stock market and how in a state of seemingly perpetual crisis, they can protect their money.

So I'm delighted to be joined today by investment manager, Jasmine Yeo, to do just that and shed some light on the murky goings on of markets over the past quarter.

Jasmine, thank you so much for joining.

Jasmine Yeo

I'm delighted too, and we've come a long way from our associate days together, Rory.

Rory

Yeah, we have. I was told to teach you everything that I knew, Jasmine, and unfortunately, it only took about half an afternoon.

So, we are back now in bear market territory after a brief summer respite, or what felt like one, what's driven the most recent leg down in markets?

Jasmine

Yeah, we had a bit of a bounce over the summer, and that's because the market temporarily pinned its hopes on the goldilocks scenario, softening inflation, slower rate hikes in an economy that would hold up. But as time marched on, whilst the US economy has been reasonably robust, with it, inflation has remained elevated and as a result, central banks had to keep up the pace on the rate hikes. So, by mid-August, goldilocks was very much chased out by the bear, and we went swiftly back to the playbook from the first half of the year. Rising rates, higher inflation, and a pretty challenging economic environment for businesses and consumers alike.

Rory

And the pain has been felt right across asset markets.

Jasmine

Yeah, it's been a broad sell off. Bond markets, for example, are having their fourth worst year since 1931, and that's created for pretty uncomfortable scenario for the industry where, unusually, low and medium risk portfolios, which typically look at two bonds for protection, have performed just as bad and in some cases worse than higher risk portfolios.

Rory

And speaking of higher risk portfolios, equities have had a similarly rough period.

Jasmine

Yeah, a similarly dire picture I'm afraid. So, the S&P500 is into bear market territory too, and we mean by that a fall of more than 20%, and the Nasdaq which is a US tech index has dropped over 30% for the year to the end of September. I think it's worth noting though that what we've seen thus far is a discount rate shock. So that is asset prices adjusting to these new high interest rates, which are rising because central banks are trying to contain inflation. And whilst we've seen prices fall, what we haven't really seen yet is we have a full panic in markets. Now arguably, with the exception of the localised panic we saw in the UK in the gilt market last week, but I'm sure we'll come back to that. But broadly in terms of flows, it's clear that investors are yet to really run for the doors. So, our concern is that what we've seen thus far may only be the first act of this bear market story and that asset prices could have further to fall.

Rory

And before we get into the specifics, Jasmine, it's probably worth a word on how the Ruffer portfolio has held up over the quarter and indeed the year to date.

Jasmine

So, the portfolio managed to preserve capital and has delivered a positive return for the quarter. Unsurprisingly, in another period where conventional asset classes, so both bond and equities as you mentioned fell in tandem, it was our unconventional protections in the form of derivatives that did a lot of the heavy lifting. We also took advantage of the market rally to reduce our exposure to risk assets. So, we're now, relative to our history, at our lowest ever equity weight of around 12.5% in portfolios, we even reduced our gold weighting by around a third which is now less than 2% of portfolios.

Rory

Jasmine, you rather intriguingly hinted at the potential for a further leg down in asset markets, what's the thinking behind that?

Jasmine

So, a lot of what we've seen so far this year we think is a wash-out of the pandemic excess as risky assets have repriced. We know that was catalysed by central banks raising interest rates to fight inflation, but what we now face is the possibly of a liquidation of risky assets as we see an unwind of the post-financial crisis excess. To our minds, in the way that leverage risk in banks was the key axis to have understood ahead of the global financial crisis in 2008. Today, it's perhaps a liquidity risk in asset managers that could drive the direction of asset prices from here, and it's a risk because the quantity of that liquidity is falling, but also, where exactly it sits within the financial system is shifting, which is perhaps more of a hidden danger.

Rory

And that really, Jasmine, is the subject of Henry Maxey's most recent memo 'so far, so good'.

Jasmine

Yes. Which, by the way starts off very glamorously in French, but if you read on you'll soon learn, it's actually on the very unglamorous subject of financial market plumbing. But don't be put off, it's really important, the essence of it is underpinned by quite a straightforward observation. And that is that in a world of zero interest rates, which we had following the financial crisis, investors make higher allocations to risky assets because they can't get the same return elsewhere. But with interest rates rising, all of a sudden, there's a reasonable risk-free alternative. So, we see a scenario where investors will want to move away from risky assets and hold high weightings in cash. And it's this switch that creates more demand for liquidity, by which I mean really just the ability to trade and has big implications for asset flows and therefore, their prices.

Rory

And it's this general degradation of liquidity conditions that could have material and serious consequences for asset prices.

Jasmine

Yes, that's right. The mechanics are a little more technical and relate to the nature of quantitative tightening as well as an interplay between commercial banks and the Fed's balance sheet - in particular something very **murky** called the reverse repo facility which we refer to as the RRP, but at the heart of what we're worried about is that when there's less money in the system, and the channels of its creation are blocked, even high-quality investments can become unsellable. So, you end up with something rather counterintuitive which is that in a liquidity crisis, it's often securities perceived as safest and most liquid that can go down sharply because investors are forced to sell what they can and not what they want to.

Rory

Jasmine, it was rather unfair of me to ask you to condense Henry's 6,000 (ish) word essay into just a few sentences, but if listeners would like a copy of the memo, then please do get in touch with your usual Ruffer contact or the manager, or drop an email to Ruffer at ruffer.co.uk.

Now, I have to say, Jasmine, the UK gilt market is not usually a subject of discussion around the dinner table in my house, but last week was a little bit different. So, the duplo version of it was: yields shot up following the government's mini budget, meaning the cost of government borrowing rose, pension funds then had to scramble to cover liabilities caused by the markdown of gilt values. And these pension funds had to sell what they could, namely UK gilts, thereby exacerbating those falling bond prices even more. Now, we know a portion of the Ruffer portfolio is invested in the UK gilt market and specifically the UK index-linked bonds or the linkers. So, how's the portfolio been affected?

Jasmine

It was a week with a bang, that is for sure. To put some context on the nature of some of these moves, the 2073 index-linked gilt, so that's the longest dated issuance available in the UK, was down 27% on the Monday, 24% on the Tuesday, and 20% on the Wednesday morning when the Bank of England eventually stepped in. It then rose a 115% on the day, and was up 16% and 33% on the Thursday and Friday respectively. So, some extraordinary moves, I'm not surprised it made the McIvor dinner table. But the portfolio came through remarkably well, owing to the portfolios defensive positioning, and that enabled it to be pretty agile in the moment. We were able to both sell some of the protective investments when they'd done their job and take advantage of some of the distressed prices and buy at or near the lows, and then benefit from the recovery as a whole when the Bank of England did step in a buyer.

But taking a step back, the sensitivity of these assets to rising yields is something we've been acutely aware of. So, it's important to consider our positioning in inflation linked bonds in the context of the wider portfolio construction where our use of offsetting assets has meant we were able to protect capital. In this instance, derivative protections against equity markets and previously, interest rate options.

Rory

Jasmine, do you continue to hold the linkers?

Jasmine

Yeah, absolutely. And, yeah, our long-term view really has only been reinforced by these recent events, and that is that policymakers will be unable to tame inflationary pressures, which we think are structural in nature, and that we'll re-enter a world of falling real yield even if nominal yields remain somewhat higher, and where the inflation linked bonds will serve as a key protective investment.

Now, having said that, we're moving into an environment of heightened inflation volatility and there will be times when we need to actively manage that interest rate risk as we have done with some success over the past couple of years, and in particular in the year to date. But they remain a uniquely well-positioned asset to benefit from an increase in long-term inflation expectations and we think they'll be the asset investors have to panic into when markets and perhaps society do become more accepting of inflation above 2%.

Rory

So, we've established, Jasmine, that Ruffer has its lowest ever exposure to equities and we've touched on the linkers holding, but the other important part of the pie is the protection strategies within the portfolio. Could you just give me a bit of a flavour on what they are at the moment and what dynamics they play to?

Jasmine

So, in short, most protection is no longer cheap, as this bear market has been more of a grind down so the cost of protection has got steadily more expensive. So, in previous years, like before the covid crash, we'd loaded up on cheap and very convex VIX call options which are derivatives that benefit from a spike in volatility, which is very much what we saw in March 2020. But this has meant that we've had to be more selective about what option protection to use in the portfolio now. So, for example, moving away from straight interest rate option protection based on the cost of the higher implied volatility, and using more equity and credit protection, and specifically we've benefited from both index and targeted equity put options. We've also had to be more tactical and dynamic, so taking advantage of that summer bear market rally to reinforce the protective positions. So, we do still have a full suite of unconventional protections, and one area that could still provide some good asymmetry we think in a dislocative move from here is our short credit exposure, which should work as a hedge even if bond yields fall as the credit spreads widen which in effect is a rise in the cost of borrowing as you might expect would happen in times of market stress.

Rory

And lastly, there's now a pretty sizeable allocation to cash in the portfolio, are you comfortable with that?

Jasmine

Yeah, absolutely. The allocation to cash and short-dated bonds has been and is currently high. For us, we think that's really a necessity. If we could find more attractively priced protective assets, we could potentially have a higher equity rates, higher protection, and lower cash weighting. But as we've discussed, that isn't currently the case. Cash isn't necessarily the terrible asset it's sometimes portrayed to be. You're now paid a decent interest rate. In terms of the short-dated bond holdings, a reasonable chunk of this is owned for the currencies, so Japanese bonds are gaining exposure to the Yen which we think will be a safe haven in a liquidation. Australian government bonds for the Aussie Dollar, which benefits from rising commodity prices, and USD bills which now give you over 3%. And I think the thing to remember here is that we're in the business of preserving capital. In the current environment, cash in the short-term at least is one way of doing that. But almost as importantly, it means we're able to move quickly and take advantage of future dislocations in markets and buy some quality investments at considerably lower prices when perhaps others can't.

Rory

Jasmine, thank you so much for joining.

Jasmine

Thank you very much, Rory.

Rory

And thank you for listening.

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