Ruffer Radio

Episode 18 – Early and ready

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Welcome to Ruffer Radio, a series of podcasts in which we explore the investment universe and share our interpretation of what's going on. In the three decades Ruffer has been managing money for clients and investors, there have been periods, although few in number, during which performance has been disappointing. Phases when Ruffer has failed to deliver on its objective to generate a positive return over twelve months, whatever the market weather. And we're in one such period today. I'm joined by investment director and flagship fund manager Steve Russell, who has lived and invested through the highs and lows of markets for over 30 years, and almost 20 of those have been with Ruffer. Steve, thanks so much for joining.

Steve Russell, Investment Director

Thanks, Rory.

Rory

Uncomfortable, frustrating, disappointing. Those are a few of the words that we and some of our clients have used to describe recent performance. But I wonder, Steve, if you might also add the word necessary.

Steve

Certainly would agree that the last six months have been both frustrating and disappointing for us as fund managers, but even more so for our clients, who've now given back pretty much all the gains we made last year as equities and bonds fell. But the really interesting part of your question is whether such periods could be described as necessary. If you're serious, as we obviously are, about protecting clients from the big and damaging setbacks in markets, then a focus on protection assets will at times necessarily mean missing out on what might seem easy pickings in the markets. In the run up to every single market crisis of the last quarter of a

century, we've been effectively too early in taking a cautious stance and delivered frustrating short term performance before eventually being proved right and protecting clients as markets fell sharply. This happened in 1999 ahead of the bursting of the tech bubble, in 2007 ahead of the financial crisis, as well as in the run up to the covid collapse and last year's correlated fall in both equities and bonds.

So I think perhaps the answer is yes, it may be necessary. If you're going to protect against dangerous market conditions, it is better to be too early than too late. And such periods of underperformance are perhaps a necessary part of delivering our long term record of protecting against every major market decline for over a quarter of a century.

Rory

Steve, can you just summarize the headlines of what's been going on both in markets and in the economy?

Steve

Yeah, starting with interest rates. They've risen faster and further than markets expected, and most importantly, look like staying higher for much longer than was forecast. This is bad news for both financial markets and, in the end the real economy, and will get worse the longer interest rates have to stay high. Just look at the slow-motion car crash that's now unfolding in the UK mortgage market. Similar pain will be felt in the corporate sector as well, as cheap financing starts to roll off now, why are interest rates staying higher? Because inflation around the world is proving higher, but most importantly, stickier than markets and central banks had predicted. So those are the two main factors going on now, looking at markets. Despite these problems that the real economy and the financial economy are likely to face, we've seen an extraordinary rally in one part, just one part of the stock market.

Megacaps focused on the dream of alternative technology, AI technology, and the idea that they will immediately transform global productivity. Not over decades, but today. This has all the hallmarks of the tech bubble of the 1999 2000 period that burst so dramatically two decades ago. We didn't join in that crazy exuberance then, and we don't intend to this time around. Then stepping back to the bigger picture, instead of a return to the old goldilocks regime of near zero inflation and interest rates that markets currently seem to be dreaming of, we believe we've entered a much more difficult period of high and volatile inflation and higher interest rates. Now, if we're right, and the evidence seems to be increasingly pointing that way, this will be a much more difficult environment for financial assets, especially when you think that you can get over 5% on cash being paid to you in the US as an alternative to increasingly risky equities and credit.

Rory

And that leads us on to a really core part of Ruffer's outlook and current positioning, and that's the threat of liquidity risk. So, Steve, what's the thrust of the thinking here? And has anything changed over the past quarter? Are things better, are they worse? Have they remained the same?

Steve

The overall picture for us is that with investors now offered over 5% risk free return on their cash, at least in the US, and cash rates rising and catching up with official rates in the UK and elsewhere, we think there is a present and growing risk of investors deciding to sell out of risky

assets such as equities and credits. Why take all this extra risk for no extra return? If this occurs, it could happen very quickly, especially with so much invested in illiquid and private assets these days. So whatever can be sold, which is mainly equities, could see sudden and sharp declines. Along with this, we've also seen central bank liquidity being put into the markets, perhaps surprisingly over the last six months. We think this is coming to an end as central banks try to pull in liquidity to try to fight inflation, which is proving more persistent than expected.

Rory

There feels to me to be kind of a contradiction at hand. So in the one sense, we're approaching what appears to be the most well telegraphed economic downturn and potentially an accompanying market sell off in recent history. The papers are full of it. You speak to anyone on the Street and they say things look like they're getting worse. With the exception, maybe of, as you referenced earlier, the artificial intelligence evangelists who think, of course, that we're going to sail through with the elixir. And then again, investor sentiment, as expressed through portfolio positioning, has turned positive. So the same people that are saying that things are going to get worse, things aren't looking particularly good, they're buying assets which suggest differently. So how do you explain that?

Steve

Yeah, this is really what's been so frustrating for us over the last few months. Just as in 2007, in the run up to the financial crisis, it seems obvious to us that things are going to be very difficult for financial markets. But back then, the party did carry on for longer than we expected and we looked disappointing for a while until reality hit and markets fell sharply. The same thing frustratingly seems to be happening again this time. So whilst we will be looking at how to adjust the portfolio to cope better, if these conditions persist for a while longer, what we won't be doing is cutting back our protections at what could prove to be exactly the wrong time.

Rory

In previous crises and I'm thinking particularly about the GFC in 2008, currencies have been really important to the Ruffer portfolio and in fact, they've been a real driver of positive returns both in the eye of the storm and on the other side. How are you expressing currency views in the portfolio at the moment?

Steve

This is really rather interesting at the moment and is changing as markets move on. What we're seeing now is currencies start to behave almost exactly in the same way as they did in the run up to the GFC. As you said, sterling is showing surprisingly strong performance given the difficult economic conditions in the UK. And people are now selling the yen once again to fund investments in higher risk but higher yielding assets. This carry trade was a key feature ahead of the financial crisis and its sudden reverse in 2008 saw that yen rise sharply and was a key factor helping us make money for clients during that crisis, when markets fell 30% to 50%. So now we put back in about 15% in the Japanese yen. This has been painful over the last couple of months and over the quarter, but we think it could soon make very powerful gains.

Rory

So the yen, that's one source of potential returns as we move into a potential crisis or a flock into safe haven type assets. But where else in the portfolio could returns be made?

Steve

Well, our protection assets in credit and volatility, also known as the VIX, are well placed to make strong returns if and when markets reverse or the economy goes into recession. Our credit protections made almost 80% gains when covid hit the global economy in 2020. And we could possibly see similar gains as high interest rates work through the system and corporate defaults rise sharply. Because it's not just UK homeowners who are increasingly struggling with interest rates having tripled. The same is true for highly indebted corporates as once cheap financing is replaced with much higher interest costs and this could see our credit protections delivering powerful returns.

Rory

So do you need to see companies actually default on this debt to make money?

Steve

No, it's not a bet against companies going bust, that's not something we do. What we need to see is people who own corporate debt get worried about whether these companies are able to service their debts or even repay them and seek to buy insurance against the risks of companies defaulting. So what we own is insurance on companies defaulting, not a bet that they actually go bust and make lots of people redundant.

Rory

Linkers remain a significant part of the portfolio and by linkers I mean the index linked gilts in the UK and also inflation linked bonds in the US. Inflation clearly has increased both in the UK and the US. If the linkers aren't delivering and generating returns now, when are they going to work?

Steve

Yeah, the index linked bonds or inflation linked bonds in the portfolio have not performed as we'd hoped so far. And the reason for this is because the market's expectations of future inflation still remain exactly where they were, no higher at all than they were in the last decade before inflation returned with a vengeance. So this means the index linked bonds, inflation link bonds, have performed just as if they were conventional bonds and made losses. We do expect this to change as it becomes clear that inflation is not going to return to 2% targets anytime soon and nor is it going to stay there. We think eventually central banks may have to raise their inflation targets if they don't want to cripple the economy with punitively high interest rates. Obviously this hasn't happened yet, but there has been some talk about it and we think inflation linked bonds could make very rapid gains if and when we see inflation expectations move up to reflect what the world is probably going to be like in future.

Rory

Great expectations indeed. So one other position, commodities - expressed in the Ruffer portfolio through shares in some oil majors and elsewhere, is that a tactical trade, is that a more structural position or is it a bit of both?

Steve

Well, whilst you could see commodities as a structural play on inflation, their current role in the portfolio has been more focused on the tactical a growth asset to offset the cost of protections if the world turned out to be rosier and growth in the global economies turned out to be stronger than we expected. Now this hasn't worked in the last few months and we're looking to see if there are better growth offsets that we could use in the portfolio. What we've seen is that commodities have effectively priced in the guarantee of a recession, but the equity market isn't pricing that in. But we have to check, and we want to check back over the portfolio to make sure it's not just the fear assets that are in the right place, but our growth assets are doing the job while we wait for things to pan out.

Rory

So Steve, as the schools are breaking up and summer is upon us, what are the sort of things that you're looking out for? Is there anything in particular you think that might shift the balance? How are you thinking about the portfolio and how confident are you in the portfolio's positioning?

Steve

The first key message I'd want to make here is that we have at Ruffer been here before, we have produced dull or disappointing returns before every single major market fall, when holding protection, though painful, has always proved to be worth the short term cost. So we think the worst thing to do at the moment on the portfolio would to be cut back on protection assets now, especially as we see markets as being more dangerous today than they were at the start of the year. We also accept we haven't quite got the balance in the portfolio between the protection and growth right in the short term and this has been costly for clients. So we are looking to improve this, especially on the growth side of the portfolio, without cutting back on those core protections. Looking forward, what do we think is coming?

Well, we think the continued draining of liquidity from financial markets and the real economy as cash returns of 5% plus prove irresistible. We think this is ongoing and could hit a trigger point for a sharp selloff in risk assets sometime in the next quarter or so. Also what we're also seeing is the growing but lagged impact of interest rates being not just higher, but staying higher for longer than people had expected. And this will impact both on financial assets but also on the economy. So far we've had a US regional banking crisis and as I mentioned, increased turmoil and difficult conditions in the UK mortgage market. But I think over the summer we could start to see real problems in corporate credits and rising credit defaults and problems in the over indebted private equity markets are probably the next signals of what's happening.

Rory

Steve, thanks very much for joining.

And thank you for listening. You can subscribe to Ruffer Radio on the App Store, Spotify or wherever you get your podcasts.

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