

Ruffer Radio



Episode 1 – Markets now and next



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Rory McIvor

Welcome to Ruffer Radio, a new series of podcasts in which we'll be exploring the investment universe and sharing our interpretation of what's going on. I'm Rory McIvor, an Associate at Ruffer. And today, I'm talking with Duncan MacInnes, investment director and co-manager of the Ruffer Investment Company. We'll be discussing – you guessed it – the coronavirus, how it's changed the investment landscape, its impact on the Ruffer portfolio, and what could happen next. Hi Duncan, welcome to the podcast.

Duncan MacInnes

Hi, Rory. Happy to be doing this. There's a lot to talk about at the moment.

Rory McIvor

Let's begin by briefly touching on Ruffer. The firm has had three to four years of fairly mixed performance, then comes a global pandemic, which no one predicted. How's the portfolio been affected?

Duncan MacInnes

Well, I think the first thing that's worth doing is probably recapping what's happened because this has been such an extraordinary period. The first quarter of 2020 had two seismic economic events on top of each other. First and foremost, of course, we had the coronavirus. But second, at the point of maximum economic disruption, the Saudis sabotaged the oil market to try and take out once and for all US shale and also Russian production. And the context in which these two events happened was one where asset prices were already at all-time highs, and investor risk appetite was also pretty elevated. So, the word unprecedented gets banded around far too

often, but it really is truly applicable here. We had the great unknown of this global pandemic, we had record speeds of stock market declines, and then the world was plunged into this synchronised global economic lockdown. And the amount of seemingly impossible things happening just seems to grow by the day. Oil traded briefly at $-\$37$ per barrel because there's such an excess of supply over current demand, and nobody has anywhere to store it. These things are just not supposed to happen in a properly functioning market or economy. As a response to all these things, governments have started to underwrite workers' wages and to bail out the private sector. And lastly, central banks have intervened to provide QE and liquidity on a scale that quite frankly would make the financial crisis blush. So, economic time as we know it has stopped, but financial time has not. And they had to take these extraordinary steps to plug the gap. And the rightness or wrongness of those steps I think will probably be debated for a long time.

Rory McIvor

So, coronavirus was clearly the catalyst in this remarkable series of events, but I'm guessing there's a little bit more to it than that.

Duncan MacInnes

Yes. Just as coronavirus is much more dangerous to people that have pre-existing conditions, the economic consequences of the coronavirus recession are much more serious because of the pre-existing conditions that we had in the market and the economy. And it's always been our view that the key is to identify whether the slope is avalanche-prone rather than which individual skier might set it off.

Rory McIvor

In light of all of that, is it worth a brief overview of how Ruffer portfolios have performed?

Duncan MacInnes

So, year to date, we're up about 2%, which compares to the FTSE in the UK at -25% and the US market at -15%. And if you look at it a little bit longer, over five years, these numbers have changed pretty dramatically recently. And all of a sudden, our 10% return, which is okay but we're not particularly proud of, actually looks pretty good compared to a UK market that has now delivered no return including dividends for half a decade.

Rory McIvor

You used an interesting little analogy just now, avalanche-prone markets. What does that actually mean?

Duncan MacInnes

Yeah, it means the set-up, the lay of the land. So, that would be a combination of the economic backdrop, the market structure, and how investors are positioned. In the broadest possible sense, we're trying to work out if the environment is conducive to taking risk. And because of the lay of the land that we saw, we thought that a small trigger could lead to a snowballing of events, and then result in a major market problem. So, we looked across the landscape, and we just saw a huge smorgasbord of risks.

Rory McIvor

And what would those risks be?

Duncan MacInnes

Well, in terms of the economy, we're worried about the record quantity of debt and unfunded liabilities that together acted like a, a dragging anchor, keeping growth low, and trapping us at zero interest rates. On the political side, we've endured the rise of populism, anti-capitalist sentiment. And that's probably as a result of inequality being so elevated, not just famously between the rich and the poor, but also between generations. And political polarisation is deeply dividing society on a number of axes. From a market perspective, despite all of those risks that I just mentioned, valuations were actually pretty high. Stocks and bonds traded at all-time high simultaneously, which is pretty anomalous through history. We also saw areas of froth in things like venture capital-backed unicorns, the rush into private equity, cryptocurrencies in 2017. These were all slightly concerning. And lastly, there were technical factors, things like the rise of passive investing, the homogeneity of institutional portfolios, the explicit or implicit selling of volatility as a strategy. All of these have unknown consequences, we thought, and made the market a little bit more fragile.

Rory McIvor

Duncan, in times of crisis, received wisdom would suggest that investors shouldn't panic, but they should just hold on. Last week, Charlie Munger, Warren Buffet's lifelong business partner and vice chairman of Berkshire Hathaway, reiterated his long-held view that the key to great investing is sitting on your, let's say, hands. What's your take on that?

Duncan MacInnes

Yeah, it's a great question. I think the received wisdom on this is both true and also somewhat self-serving. So, there is absolutely truth to the notion that time in the market is more important than timing the market. Staying the course and being invested for the long term is usually the best thing to do. So, hold on, stay invested, don't crystallise the so-called paper loss. Well, the thing is that I think that calling them paper losses demeans them because at that time, they feel very real. But staying invested has traditionally worked especially over the last 20 to 30 years. That was the period that we and others have called the golden age of the central banker. Investors have been trained like Pavlov's dogs to buy every single dip. And that's because central banks have always come to the rescue. The idea of the Greenspan Put came from that. Lower rates and stimulus always get things back on track, and investors were made whole in a fairly short space of time. But today, even central bankers in their omnipotence have suggested that they are running out of tools. And the asset management industry of course has incentives in this too. They are incentivised to keep clients invested because they can charge fees. The last thing that they want in a middle of a bear market is clients selling up and leaving. So, there are other reasons clearly why the buying whole for the long-term narrative is pushed so hard. So, the key point I think is that there have been times when panic would have been actually inappropriate action.

Rory McIvor

Such as?

Duncan MacInnes

Well, if you look across history, there's been long periods of time that the market has gone nowhere. Investors in the stock market in the late 20s or the 60s effectively went flat or sideways before inflation for 15 to 20 years. Now, in those instances, telling clients to just hold on and close their eyes was not really much use to them. So, it all depends on the context that markets and macroeconomic set-up that I referred to earlier.

Rory McIvor

So, what are Ruffer doing?

Duncan MacInnes

Well, at the moment in our portfolio, it's a process of evolution, not revolution, I think. Thankfully, we came into this crisis with a lot of protection in the portfolio. So, we were pretty well-set. But I would contrast it with our experience at the bottom of the market in 2009. And of course, we didn't know it was the bottom of the market at that time, but we aggressively switched the portfolio out of conventional government bonds, and increased our weighting to equities. Today, I would say that we are much less sure that the worst of the economic and market pain is behind us. So, rather than adding risk to the portfolio, what we've been doing is dialling down the defensive side. So, that means taking profits in the unconventional protections, particularly the options. But we've also been increasing or reallocating towards gold equities and longer-dated US inflation-linked bonds.

Rory McIvor

Duncan, at times like this, it strikes me that the psychology of investing becomes ever more important. What are the psychological and behavioural traps Ruffer is seeking to sidestep?

Duncan MacInnes

So, at the highest possible level when you think about what we're trying to do, the approach is about trying to be roughly right as opposed to absolutely wrong. So, we have strong views as to how we think markets might turn out, but we don't want to bet the ranch on that. So, when you start to admit that you don't need to know for sure what's going to happen, it can actually be quite liberating because clients are not paying us to see the future. What they're paying us to do is to mitigate risk and keep their capital safe. So, today, with regard to potential behaviour traps, I think we're in this very odd information vacuum that allows your imagination to run wild potentially. We all know that the economic news is bad. We can see it in our own lives, in our own expenditure, you know, cancelled holidays, much less discretionary leisure spending, et cetera. But we don't and we can't yet know exactly how bad it actually is.

Rory McIvor

So, not yet. But when or how, will we know how bad it is?

Duncan MacInnes

Well, we're starting to see dribbles of economic data even the last few days, and they are pretty apocalyptic. But soon, we will have a much better picture. But the point I would emphasise is that events have just moved so quickly. So, this sell-off was the fastest on record as I mentioned earlier. The economy went into full lockdown in a matter of weeks. Just two months ago on

certain measures, we had the best economy ever as Donald Trump kept telling us. And the fact that we've moved from that to this has only added to the sense of disorder and chaos. People just have not had time to process it, I think much less prepare for it. So, in some sense, I would suggest that we've had a stock market crash, and some people have probably missed it. If you haven't looked at your investment account for a few weeks, you might have missed the fact that the stock market fell by 35%, and then bounced by 20%, leaving it -25% year to date to today. Because in that interim chaotic period in March, people had other things to worry about. They're worried about their own family. Had they stockpiled toilet paper? Was granny okay? Was the spare bedroom set up to work from home? Were the schools going to close? Yeah, they have to worry about their own job.

Rory McIvor

It strikes me that we've never actually had a situation where so many fundamental economic and lifestyle questions were posed at the same time, and with such little warning. The values of people's pensions I guess were to some extent the least of their worries.

Duncan MacInnes

Yeah. So as we emerge from this information vacuum, I think things will settle down and investors will start retailing, private investors will start to take stock. The first wave of selling that we saw in early to mid-March was from broadly leveraged players. So, that would be hedge funds, risk parity strategies, highly sophisticated financial participants. What we didn't see was much of real money players. So, that's people like sovereign wealth funds, endowments, charities, and of course individuals. But as many of those participants, the real-world financial strains — and we're pretty confident they will if you think charitable donations have probably declined, people are losing their jobs — they will be forced to call on their portfolios to supplement their cash flows.

Rory McIvor

So, that would result in a second wave of selling?

Duncan MacInnes

Yeah, potentially.

Rory McIvor

Duncan, how is Ruffer interpreting things? Is it better to be a scientist or a historian? Are you saying the devil is in the detail or are you taking a bird's eye view?

Duncan MacInnes

Well, I'm afraid to say that being either a scientist or a historian is probably preferable to being an economist unfortunately, but entirely understandably in this instance. This is will go down as yet another financial or economic crisis that economists will have missed, which will only enhance their reputation that they're a little bit like weather forecasters who don't understand storms. Now, the other trend that we've seen is that everyone in the city in Wall Street has spent the last two months racing to achieve some form of competency in epidemiology, but I would say that the value in that knowledge has a very short shelf life. And because everyone is trying to do it, it probably offers very little investment edge.

Rory McIvor

In that sense, how do you think things pan out from here?

Duncan MacInnes

We think that the market has two bridges to cross before we can see what things will be like on the other side. The first bridge is the virus bridge. So, that would be some form of peak in terms of new cases or deaths, which would allow us to start forecasting return to work. And that would be coming hopefully very soon. But the second, and I think more significant bridge, is the economic bridge. What does a return to work look like and what are the ripple effects and consequences of that when economy is a vastly complex dynamic system? It is not like Netflix where you can just press pause and then resume whenever you're ready. So, at the moment, we think the market's getting very excited about crossing the virus bridge. And that would explain the 20% bounce in equities since the low in the middle of March. But due to this information vacuum that I mentioned, we just don't yet know how difficult the economic bridge will be to get over.

Rory McIvor

Duncan, I've got visions of rickety rope bridges crossing over stormy seas as opposed to big steel constructs.

Duncan MacInnes

Yeah, I think that's right. And we don't even know how long these bridges are.

Rory McIvor

So, on that point, what do you wish you could know, but don't?

Duncan MacInnes

Well, a lot of people think investing is about being able to see into the future. But of course, we can't do that, and nobody else can either. So, what we try to do is to build a portfolio that is all weather. So, another way of thinking about all weather would be to think of it as future agnostic, a portfolio that will preserve capital, but also hopefully do well in as wide a range of outcomes as possible.

Rory McIvor

Are you dodging the question a wee bit there?

Duncan MacInnes

I think...okay, fine. I think the trillion-dollar question, if I was forced to come up with one, is on the other side of the coronavirus recession, does the unprecedented levels of stimulus that we've seen result in inflation? Because we've seen World War II levels of stimulus. And yet, this war could be over in three to six months of economic disruption. So, what are the consequences of that? In the financial crisis, we saw what at that time were unprecedented levels of stimulus. And yet, afterwards, we had a decade of pretty benign RPI and CPI inflation.

Rory McIvor

It's my understanding that lots of people don't necessarily believe those inflation statistics.

Duncan MacInnes

Yeah, and there's good reason for that I think. But you can make nuanced arguments about the cost of a middle class lifestyle running far ahead of CPI or you can say, 'Yes, the inflation's been in asset prices and collectibles like art and wine and fancy cars.' But what we didn't see was the general reported inflation that many — including Ruffer, to be fair — were expecting as a consequence of a QE post-financial crisis.

Rory McIvor

Harking back slightly, what do you mean by stimulus? Presumably, that's the monetary policy on one hand. So, slashing interest rates, printing money, and fiscal policy on the other - the government stepping in to provide cash to businesses and individuals, and in essence, putting money into people's pockets.

Duncan MacInnes

Yeah, exactly. So, monetary policy is done by the central banks. That would be cutting interest rates and creating money to buy assets and to stimulate markets. Fiscal policy is cutting taxes or increasing spending or giving via something like infrastructure projects or the business relief grants or the furlough payments. But the key difference that I would emphasise is that in 2008, the stimulus went into the banking system to fill a void that had been created as a result of the collapse and all those complex financial instruments. Today, the stimulus is going to go directly to people who desperately need the cash, and therefore will spend it. And I think that seems far more likely to be inflationary. Now, inflation is often described as too much money chasing too few goods. And I think it looks like that's the sort of scenario we could be in now. There's going to be a lot more money sloshing around the system. And it's entirely possible that bankruptcy as a disruption to supply chains will result in fewer goods for that money to chase. Taking it down to the most granular level, on my rationed socially distanced trips to the supermarket during lockdown, I noticed that offers have almost completely disappeared. So, key staples were also in pretty short supply, things like pasta, eggs, and milk. You know, what does a bag of pasta normally cost? Maybe a pound? Well, would I have gladly paid £2 if it meant that I could actually get my hands on some? I think I probably would have. Now, hopefully, this isn't like David Cameron and the pint of milk moment. But the point I'm trying to make is that sticker prices are meaningless if there's no supply to meet my demand. Yeah, that would be 100% inflation if only the two could meet. But to get back to your question, why is whether we get inflation or not the most important question? Well, it's because the portfolio that an investor would want to own for a disinflationary low-growth world, which is the one we've been in for the last decade, is completely different from the portfolio that one would want for an inflationary higher nominal growth world.

Rory McIvor

Duncan, is anything safe?

Duncan MacInnes

That's a very, very important question. So, we all know that one of the consequences of the financial crisis was a decade of financial repression. Globally, interest rates came down to zero to try and stimulate the economy. But who this punished was savers. They put our clients in a bind. In 2007, you could earn 5% on cash and deposit or on a UK government bond. In 2020, you earn less than a 10th of that in either of them. Now, the whole point of zero interest rates is to force people to take more risk, to force Mr and Mrs Miggins to sell their government bonds and invest in something spicier to replace the income that they need to live off. So, that forces them out into corporate bonds, high-yield bonds, and equities. And to get 5% today on an income return, you need to be in the stock market, which of course is very risky. So, we've been saying for a few years that there is no such thing as safety anymore. And certainly, anything that pays a decent income is unlikely to be safe and certainly would contain hidden risks. Now, I've met lots of people over the last few years who have moved money into consumer staples, utilities, or oil stocks or perhaps they've bought a buy-to-let property because they thought, yes, you know, the capital value might fluctuate, but the dividends, my income will be safe. And unfortunately, even that is proving to be a false assumption because we are in the middle of seeing a brutal wave of dividend cuts across a range of industries, and of course, tenants not paying rent as this recession bites.

Rory McIvor

Duncan, you've talked a lot about protecting capital, but what about growing it?

Duncan MacInnes

Yeah, you're absolutely right. I mean, we're here to look after clients' capital first. But of course, we have to also try and generate a return. And the unconventional protections that I mentioned earlier were a huge headwind to performance over the last few years. We've been positioned for major dislocation like this since 2015. And the cost of carrying that protection in the portfolio was prohibitive. Frankly, that's probably why so few others were doing it. So, very roughly, I think it's fair to say that the run rates cost of carrying that protection in our portfolio has dropped from 3% per annum to 1% per annum, which is a huge weight off. Literally, that was like swimming with one arm tied behind your back in rising markets. But we felt we needed to have those protections there because that was the only way we could promise our clients that we would protect their capital in the next sell-off. Now, going forward, the advantage we have from here is that, mentally, I think we're in quite a different place for most of the rest of the market. Just as in 2009, we're in a position to take advantage of the stressed opportunities. The position that we're in now is that we can be on the front foot. Psychologically, I think you can approach things quite differently if you're up year to date versus if you are nursing large losses with the financial and psychological scarring that comes with that.

Rory McIvor

So, what does being on the front foot look like to you? Does that mean you're buying equities?

Duncan MacInnes

Well, we aren't jumping in yet, but we have started to sort of sift through the rubble. I love the analogy that a crisis is a little bit like dynamite fishing. You hear the boom, and everyone feels the shockwave, but it takes a little bit of time for the dead fish to float to the surface. And

because of the speed with which this crisis has happened, and the additional impediments to easy information flow due to lockdown, we haven't seen yet many high-profile casualties or bankruptcies. But I'm pretty sure that we will. And I think that would be one sign that we're nearer to the bottom and closer to that better environment to take risk.

Rory McIvor

Duncan, I'm not sure I'd like to go on one of your fishing trips. But moving on...

Duncan MacInnes

(Laughter) I should disclaim that dynamite fishing is illegal, I think. (Laughter)

Rory McIvor

(Laughter) Now, Duncan, this is a huge question to finish on, but give it a go. What happens to the economy?

Duncan MacInnes

Well, yes, it's saving the best for last. I think that this experience that we are living through is one that we will tell all of our grandchildren or tell our grandchildren about because we've just never had anything like this before. And so, anyone trying to make predictions is flying blind and making educated guesses or assumptions. But I think it helps at moments like this to be quite creative in the way that you think about things. So, the original big decision for governments was one of lives versus livelihoods. And it reminds me of the American military officer in Vietnam who explained his tactics by saying in order to save the town, we had to destroy it. And that was a little bit like the government's position a month or two ago. We placed the economy into an induced coma in order to halt the spread of the disease and to save lives. Now, that was almost certainly the right thing to do, but there are unknown consequences in terms of the counterfactual. How many lives will be lost as a result of the increased unemployment, the increased divorces, addiction, and crime that are all associated with recessions? And this recession is one that we willingly accepted.

Rory McIvor

So, I suppose the key question is whether those costs actually outnumber the deaths caused by the virus.

Duncan MacInnes

Yeah. And that's not for me or you to say, but philosophers, historians, and economists will debate that point for decades. And I think the next point is that when the virus has peaked in terms of cases and deaths, as a nation, and every nation individually, we'll have to have a debate about the return to work. And it looks like that will be sometime in the early summer, maybe. But the complications around that are endless. Presumably, it will be phased or staggered, but the chronology has to make sense. For example, there's no point in a widget salesman going back to work if there are no widgets yet in stock because the factory is still closed. But there's a bigger, larger game theory dilemma, which I think will be very problematic for large corporations. So, who wants to be the first big corporation to send their employees back into what might be perceived as danger in today's litigious PR-focused society? This is

treacherous. And therefore, I think what we'll find is that it will happen more gradually than we may assume.

Rory McIvor

Duncan, people talk about the shape of the recovery. Do you have an idea or a guess as to how that will look?

Duncan MacInnes

Yeah, yeah. There are so many shapes. There's a V shape, a U shape, an L shape, a Nike Swoosh, a square root sign. And of course, we don't know, but I think it seems to us that a V-shaped recovery is probably too optimistic. So, at this stage, we know that 22 million Americans have lost their jobs in the last few weeks, and this number seems likely to keep increasing. And the sheer scale of these numbers and the complexity of matching those unemployed people with new jobs plus the reticence of people to dive right back into the nitty-gritty of public transport and so on in the same way that they once did I think seems to necessitate a slower, more gradual recovery. Now, on the supply side, I think it seems highly unlikely that despite all of these myriad government support schemes for businesses, employers, that the actual hard cash is going to get to where it needs to be in sufficient time to at least stop a decent portion of vulnerable businesses going under, because an extended period of zero sales or cash flow is like a test as to how long your business can hold its breath underwater. And every day that passes in lockdown, the weakest businesses are drowning. And even the strongest will not be able to survive indefinitely.

Rory McIvor

So, Duncan, how do you think this actually impacts the consumer side of the economy?

Duncan MacInnes

I would say that we're yet to see the extent to which it changes consumer behaviour. In 2008, the world sort of felt the recession coming. Problem started in 2007 and then peaked in 2008. This was completely different. It was a sudden stop. January was boom times. And by March, we were in a depression. And I think that could have a profound impact on the consumer's desire to have a rainy day fund, a bit of contingency cash, and to generally just behave a little bit more prudently going forward. Because once someone has experienced how quickly it can all be taken away, I think they will act differently. The thought experiment that I've asked myself is when will you be the same consumer that you were in January and not exhibit some sort of caution which corresponds to keeping yourself and your family safe? You can...the government can send people back to work, but can they actually force them to spend their money? And the last the point I would make, and I think this is going to be the most significant change from the perspective of corporate behaviour and they will knock on to the market, is that there is this previously implicit but now very explicit trade-off between optimisation and resiliency.

Rory McIvor

So, it could be that corporations and businesses simply become more risk-averse.

Duncan MacInnes

Yes, I think that's going to be the trend. The story from boardrooms over the last couple of decades has been one of globalisation, optimisation, financial engineering, and shareholder value. Companies have been structured for and have iterated towards being leaner, faster, and more efficient. And you can see that in a number of ways from complicated global supply chains to taking on cheap debt and paying it over cash to return money to shareholders. And the virus has revealed all of the flaws in this model. Particularly in the US, corporates have become highly evolved to operate in a globalised, interconnected, stable world. And they didn't have much slack, and there wasn't much contingency planning. And the consequence of all of this I think is that mentalities will change in boardrooms and management suites. Because to avoid the potential embarrassments that we have been revealed, I think robustness in the future will be encouraged and prioritised. So, what does that actually mean? Well, it means shorter, more local supply chains. That means reshoring manufacturing, deglobalisation, holding more cash on hand, more inventory, more working capital, having a broader and more diversified array of supplier relationships who are not reliant on people, rest debt, lower levels with shareholder payouts, and therefore, less primacy for shareholders. In a sentence, summing all that up, I think it means just in case rather than just in time.

Rory McIvor

Clearly then, Duncan, there are huge political implications of this change, but what does it mean for investors?

Duncan MacInnes

Well, I think that the only thing that all of those points I made have in common is that they are bad for corporate profit margins, but they are good for ensuring that businesses will survive the next crisis. And just as an aside, I would say this is actually the I-told-you-so moment for corporate Japan. Because for so long, they have been criticised for offering or for considering a broad range of stakeholders and for having large cash balances and lazy balance sheets. Now, they look quite clever for taking that approach.

Rory McIvor

Duncan, let's bring it to a close. How would you summarise the current outlook?

Duncan MacInnes

Well, it's our view that we are moving through an economic regime change. So, coronavirus is not the end of something. In fact, it's just accelerated a lot of trends that were already in motion. So, inequality, populism, deglobalisation, and perhaps environmentalism and government involvement in our daily lives. We've run articles on all of those things in the Ruffer Review, which is our annual thought piece publication, and that's on our website. But the conclusion is that we think this will result in a wholly different economic and market landscape going forward. But what will still be essential is to focus on keeping clients' capital safe. Now, before this event, we worried about what we called avalanche risk, and we worried about valuation risk. Today, I think we're still facing valuation risk perhaps just slightly lesser extent, but we're also facing inflation risk and the fact that shareholder capitalism is likely to be under threat. But because we've managed to preserve capital through this crisis so far and deliver a positive

return, we're in a position to be able to be opportunistic and pick up bargains as and when they emerge because I think it's too much to hope that it's plain sailing from here.

Rory McIvor

Thank you, Duncan.

Duncan MacInnes

Thanks, Rory.

Rory McIvor

Thanks for listening.

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