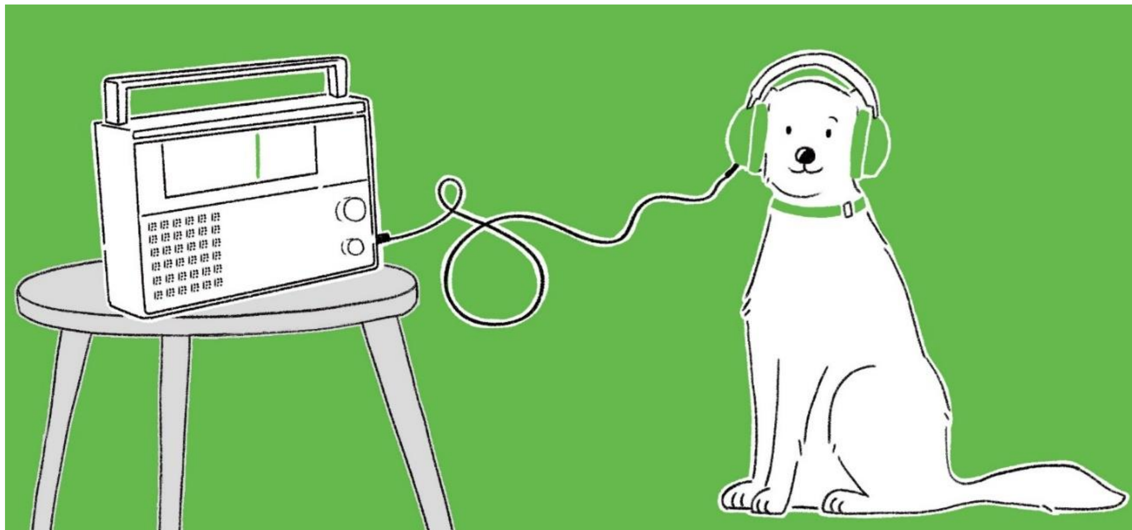
Ruffer Radio

Episode 13 Winning by not losing – protection strategies



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Rory

Welcome to Ruffer Radio, a series of podcasts in which we explore the investment universe and share our interpretation of what's going on. Over the next few weeks, tennis fever will grip the nation – as it does year after year. All eyes turn to the championships at Wimbledon. Racquets are dusted off, tennis balls retrieved from the back of cupboards and we take to courts across the country inspired by the world's best and seeking to replicate their cross-court backhand slices which are made to look so very easy.

In 1973, Simon Ramo wrote a book entitled *Extraordinary Tennis for the Ordinary Player*. In it, he showed that in the recreational game of tennis, roughly 80% of points are lost, not won. Usually, the player who comes out on top is the one who makes fewer unforced errors, not necessarily the player who hits the most winners.

The principle of winning by not losing is at the heart of Ruffer's investment strategy, and in current market conditions, in which almost all conventional assets have shown their vulnerabilities, hitting winners has become a whole lot more difficult. So, investors are looking to more creative protection strategies to ensure they don't lose.

My name is Rory McIvor and today I'm delighted to be joined by Investment Director, Lauren French, and Research Director, Andrew van Biljon to discuss how Ruffer's protection strategies have evolved in a much-changed market landscape, and we'll look at what might be needed to preserve the real value of assets in this new market regime. Lauren, Andrew, a very warm welcome to you both.

Lauren

Thanks, Rory.

Andrew

Thank you.

Rory

Lauren, I thought we might begin with a bit of an overview as to why protecting the downside, why protection is so important to you at Ruffer.

Lauren

Well, capital preservation is at the heart of everything that we do here at Ruffer in the way that we construct portfolios, and what we found is that there's a huge power in protecting against the downside. It's very difficult to make up for a loss that you experience in your investment so if we start with £100 and we lose 50%, and we get to £50 pounds just to get back to where you started from, you need 100% growth. So really it's that power of compounding and not losing money over time which has been demonstrated through Ruffer's history.

Secondly, avoiding volatility is really important for those clients who have drawdown requirements in their portfolios. So, in a time when your portfolio's heavily down and you draw from it, it actually has an erosive effect over time. By producing a less volatile journey and creating fewer 'bad times' to draw from your portfolio, that can actually lead to powerful outcome in the long run, too.

Rory

And Andrew, within a broad overview of the Ruffer approach, could you just explain a little bit about the practicalities involved?

Andrew

Absolutely, yeah. I think it's important to note that this has always been Ruffer's approach. It's just that the way we've had to go about doing it has changed slightly and that's driven by market conditions. But fundamentally, what are we trying to do? We're trying to build a portfolio of offsetting assets, but obviously, it's no good if they all offset each other perfectly and you end up standing still. So, we need things that will do well in different scenarios and we need to balance those out, and most important, we want things that we call 'convex'. Now what does that mean? It means something that will do much better and will accelerate in a certain direction if things are moving in its favour. And if you can balance those types of investments out, you can end up with something that does well enough in normal times, but in extraordinary times, does even better and can lead to a very powerful long-term effect.

Rory

Lauren, perhaps it would be helpful to discuss how the history of Ruffer's protection strategies have evolved? I mean, Andrew mentioned how what we're doing has remained the same throughout the course of Ruffer's history, but clearly, the actual assets that you own will be very different now perhaps to what was helpful and useful in market crisis gone by. An overview would be helpful…

Lauren

Absolutely.

Rory

…but obviously, you don't need to take us through every strategy at every mood and time.

Lauren

Yeah, we'd be here all day if we try that. But there are some discernible themes if we look back through history. The key point is that, yes, the nature of the offsetting quality of assets has changed, it's a very difficult landscape now which makes it difficult to identify safe havens – the offsetting qualities in the portfolio right now are very different to history. But I think one important tactic that we've seen through previous inflection points at Ruffer is the avoidance of overvalued areas. So, if we take the .com era as an example, avoiding all technology, media and telecom stocks in the lead up to the dot.com crash was a really powerful way of protecting against the downside and similarly, in the financial crisis, avoiding financial stocks.

Rory

And Lauren, that sounds very easy to do. You just don't own overvalued assets. Why do investors get caught up in owning the stocks that are the flavour of the day?

Lauren

Well, I think, it's the attractiveness of the returns in the short run and the stocks that are in favour and are popular are likely to be those that do in fact outperform in the short run. So, we try to take a step back from that. Not to be deliberately contrarian, but just to identify overall portfolio assets that blend together nicely to produce this portfolio that we believe will be robust in different market conditions. So, I think importantly for us, when we look back through the past, sometimes our protective positioning has been taken well in advance and so, the avoidance of the popular stocks can require patience and trust with our approach. You know, avoiding internet stocks at the time when the market was booming, avoiding financials, and more recently, avoiding tech stocks, you know, Ruffer has stood out from avoiding the popular frenzies which have performed well, but that has then been validated in times when we've seen the sell-off.

Rory

And that was avoiding financials in the great financial crisis in 2008. So, you said that often you take a protective position quite early on. What were the protective positions you actively bought into in 2001 in the dot.com bust and then again, in 2008 and in the covid crash of 2020?

Lauren

In the lead up to the 2000s, it was very much a government bond position outside of equities. So 55% of the portfolio was invested in highly rated UK and European debt and cash. And currency exposure here favoured sterling and the euro. So, really, it was that kind of traditional flight to safety that really helped us in that time, and also, holding the unfashionable equities, just as the food and bus companies look stupid in 1999, they looked great in 2000, and government bonds really helped to offset during this period too. Whereas in 2008, it was very much more currencies, so positioning the yen and the Swiss franc, sort of the traditional flight to safety with ultra-defensive Swiss gilts and Japanese equities which helped. You also then asked about covid. Well, back to Andrew's point on convex payoffs during the lead-up to the pandemic, we were

concerned about the correlation of these safe havens so we were holding less conventional assets in the form of options and credit protection and these were what helped to offset losses in 2020.

Rory

Andrew, we've discussed at length on Ruffer Radio and elsewhere how the rules of the game appear to be shifting beneath our feet. Conditions today in markets are markedly more challenging perhaps than they have been at any point in recent history. How exactly is this the case and how does that change your approach to protection strategies?

Andrew

I think as investors in the market, many of our listeners can probably feel this day-to-day by the price moves they're seeing and some of the losses they've experienced, but there are three things that really we can point to as direct evidence of what's different about today. Now, the first one is that asset classes, and by that I mean, all sorts of different asset classes, so bonds, equities, commodities, are all being driven by the same couple of risk factors. So, there's only really one or two kinds of generic factors that are driving prices right across the board and that's quite unusual, and we can measure that and we've sort of seen that that's trended up over the last 15 years or so. Now, there are a number of reasons we could point to for why that's the case. It probably has to do with central bank intervention, the structure of markets today, the impairment of the risk function through commercial banks, but the upshot is that it's much harder to find diversifying assets and to build a portfolio of these assets like we're trying to do that can withstand most market environments. The second thing is that we're seeing a much higher incidence of tail risk in equity markets.

Rory

What do you mean by tail risk?

Andrew

So, tail risk is the events that happen in the tails of distribution, the ones that happened less often. Now, normally, that's fine because you could say that they have it less often therefore they're not important. But we are seeing big negative events in the tail happening more often than they used to, and also those events are more severe than they used to be. And again, there's probably a few factors we could point to, to do with market structures and risk factors, but again, as an investor, you're sitting there day-to-day and you're experiencing very sharp and very large drops in the equity market that you haven't necessarily seen before, at least at the same frequency. And then the final thing is one that everyone's very keenly aware of but we're at the end, basically, of a 40 year downtrend in interest rates ever since the inflationary period of the 70s and 80s. And that, you know, we're not saying that that necessarily needs to reverse completely and start going all the way back up the page, but it is a big change in markets and it does mean that the relationships between assets are going to be very different, and the way we approach investment and portfolio construction is going to have to change as well.

Rory

Andrew, more recently, you've begun using alternative protections, and Lauren referred to some of the credit positions that were taken in 2020, and indeed, the volatility call options, is that the focus of the protection strategies in the Ruffer portfolio today?

Andrew

It is. And I think it's important to kind of get to why we're using the stuff. Because in the good old days, you could go and buy US treasury and be assured that if the equity market fell, that treasury would probably go up and value or at least be less volatile, and that would mean that your portfolio overall was fine. But because we're at the end of that big downward trend in interest rates and because we're seeing inflation coming back into markets, you can no longer rely on these assets that used to be very reliably offsetting in the past. So, we're finding we're having to go out and find things that we know will be protective, and that means engaging in the derivatives market and using things like equity index options, FX options, and also, protection on credit indices. Unfortunately, when you start to use those instruments, you tend to suffer a drag through time. So, they'll cost you money to be in those positions, and that's led a lot of investors to kind of shy away from them because returns are hard to come by, as we all know. But we feel that actually, the opposite approach should be taken. You should be willing to incur those costs which then allows you to invest more in equity markets and other assets than you otherwise might, and if you pick the right protections that are convex, again, which go up by more than your assets are falling in a bad scenario, then the overall balance of your portfolio will mean that you're protected. You should appreciate through time but in bad times, you'll hopefully have a positive skew to your returns and it'll go up very strongly. And that's what we're trying to do here, and those are the kinds of instruments that we're looking for and engaging with today.

Rory

So, Lauren, let's lift the lid slightly on those protection assets. What do you currently have in play in the portfolio today?

Lauren

So, one of the key protective assets that we've got in play for the long-term are index link bonds, and that's reflective of Ruffer's long-term structural view around higher inflation, but in the short run these are very much vulnerable to rising interest rates and we've spoken about this before, Rory, but it's crucial to us that we can continue to hold them. So, we're holding swaptions to protect against the fall in the bonds, which was what we've seen significantly this year.

Rory

And just for listeners who might not be acquainted with swaptions, could you just explain how they work?

Lauren

It's effectively an instrument which goes up in value when interest rates are rising.

Rory

And that's one element of it. So, you're protecting against interest rate risk, but there's also some protection strategies within the credit sphere as well. Is that right?

Lauren

Yeah, and some equity market downside protection. So we own puts which we've held throughout this year. These are puts on individual equities which are designed to go up in value when the equity market's falling and they've been very important this year. And then onto credit, as you mentioned, these are credit strategies which effectively go up when there's more disorderly sell-off in the bond market, so either when corporates look more likely to defaults and needs credit default swaps which go up in value significantly in more turbulent times than the bond market.

Rory

And Andrew, the assets in the protection strategies that you've used in the Ruffer portfolio have been iterative over the course of the firm's history, but they really have altered quite significantly over the course of the last couple of years or so, and the hunt for convex payoffs as you said has become all the more trying. It'd be really helpful just to get an understanding of how these changes have manifested and to get a sense of the practicalities of managing the protection strategies on a day-to-day basis.

Andrew

Well, pre-covid crash, our job was quite easy really because the market was fundamentally mispricing the tail risks we've been talking about. That market didn't really think they could happen and they weren't being priced into these protections. So, we had stuff that did very, very well in that crash and that was fine. But after that, we then found that in most of these areas that we were using, the pricing was very much there after the covid crash which makes sense because the market just experienced it. So we had to start looking for different ways to try and achieve similar protection, and the first direction we went into was altering the specific thing we were holding. So, the example here is we used to protect equities very directly but after the covid crash, we had to look at FX as a kind of a stand-in for that. And there are certain FX crosses that you know will move in one direction very strongly if equity markets are falling, and that's the kind of thing we'll look at. And then you have to acknowledge that you're taking a bit of risk there because you're relying on that correlation between the FX and the equity market to hold. And other things we've done is we've looked at targeting more specific areas of the equity market as well. So we all know that the tech sector sort of ran away with itself a little bit after the covid crash since the recovery, and some of those areas we found were getting completely overblown and that protection on those equity industries, those sectors of the equity market at least were probably not pricing in the full extent to which they could fall especially if that sort of crowded mentality of the markets started to reverse, so the kind of mid-cap tech sectors where we were looking for those types of thing. And then coming into this year, we found that, you know, the biggest risk we were worried about was the perception of inflation falling back very strongly because that will impact our inflation-link bonds, it'll impact things like energy stocks. So, we looked at the FTSE 100 UK index as a good proxy for that kind of measure and puts on that index again were not as expensive as they otherwise might be if those bad events come out. So, everything I'm talking about here is a kind of, it's sort of a conditional mentality. You don't think about how markets are as they sit today but you think about what the kind of bad case will look like for your portfolio. And once you can get your head around that, you can then start to think about which protections will work in that conditional scenario and then look at the pricing of all those different options and pick the ones that are necessarily pricing in those bad outcomes and go from there.

Rory

Andrew, it sounds like your job is altogether rather doom and gloom, and you're constantly thinking about what could go wrong which I'm sure is very fun on a day-to-day basis… Lauren, to wrap up, we've talked a little bit about what we currently have in the portfolios, but perhaps if you could just recap the key tenets to Ruffer's protection approach.

Lauren

Yeah, and you used the example of tennis at the beginning wherein I think that provides a really good example of how we approach our portfolio construction. A tennis player will have their ultimate game plan and their style, but they'll have to maintain flexibility and re-evaluate their strategy depending on what they're faced with. So, for us, it's a preoccupation with keeping clients safe and that's always going to remain the same across market cycles, through different challenging investment regimes. But the approach that we take to portfolio construction is different and it has changed through time. We're having to move quickly and with agility within a crisis, change what we own, and really test our portfolio to make sure that we're comfortable as far as we can be, that it will be robust and withstand different conditions. But in the current market environment, we see the real need for active portfolio management, that portfolios will need to be steered along the journey and this requires new skills and new ways of thinking. But we remain confident that we have the right mix of different assets to face the challenges that we see, but also to capture opportunities in the new market regime.

Rory

Andrew, Lauren, thank you both so much for your time. And thank you for listening.

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