Quarterly notes on investing
Q2 2012

View from a mountain top

There is a time in every cycle when politics, philosophy and economics dominate the financial debate. Most of the time such rarefied discussion is bypassed, especially in bull markets. Excess liquidity has no time for reflection. It is only when we have endured a period of intense liquidity withdrawal that investors are comforted by a search for back to basics investing.

This year politics has come to the forefront; elections in the USA and France are grabbing quite a few headlines. The great debate of who should pay for the sins of 2007-2012 rages on. Of course it is those terrible bankers, but in reality, it is everyone who borrowed money they knew they could not afford.

The search for a scapegoat does not stop there. The new opprobrium is old wealth. Certainly the wealth gains enjoyed by some over the past thirty years can hardly be described as the product of hard work, entrepreneurship, innovation and superior competitive advantage. Gains in real estate prices were a factor of housing shortage, cheap money and strong demand. A famous 1980s advertisement for a stock-broking house had the punchline “We make money the old-fashioned way - we earn it”. Today the whole political debate has turned to earned wealth rather than wealth that just happened to fly on the thirty year liquidity boom.

March’s UK budget is a case in point. UK residential houses worth over £2m are now subject to a 7% stamp duty on purchase. That may not deter many purchasers at that level and the Chancellor of the Exchequer is bullish about how much revenue this will bring in. History tells us that changes in political philosophy do not stop at one measure. The new political insistence that the wealthy must pay their share will gather emphasis and this stamp duty measure will not be the last. We should not be surprised to see other countries take up the cudgels against old wealth. Old or new, the next part of the debate will be how much you can leave behind when you die. I would expect the discussions to intensify now that we have opened that particular Pandora’s Box.

Meanwhile, a more sinister grumbling from politicians is seeping into our investor reckoning. Who is going to take out Iran’s nuclear capacity? Sabre rattling from all sides may be a pre-agreed danse macabre, where actually nothing much happens, but as a Middle Eastern expert of some renown said to me last week - Do you think this Israeli parliament wants to be remembered as the one that did nothing while Iran set about arming itself with nuclear weapons? So much of the sabre rattling from all political sides reminds me of the build up to the First World War. The assassination of Archduke Ferdinand should never, in itself, have lead to the great conflagration but in the world of unintended consequences, it did. Oil prices look to be heading up and I do not think this is a political situation that can be ignored.

The politicians who have to take responsibility for stabilising and calming the Euro are praying for a quiet period. Frau Merkel looks glummer by the day, probably as her finance minister tells her how much the Euro rescue is costing Germany, and Monsieur Sarkozy smiles as if retaining Presidential power in the coming election is quite a challenge. Most critical for all those Euro politicians will be recovery in growth in Euroland. No signs yet that they are going to get a significant boost soon and all the problems of unemployment debt and deficit remain. There is not much sign of spring in Europe.
Investors naturally review their philosophy in these times. I sense a great debate about public equities. Most institutional investors have not enjoyed a real return from global equities over the last ten years and there has been great uncertainty over the rally that started in stock markets last October. In the current climate of very low interest rates, investor philosophy has focussed on equities that pay good dividends with the prospect of further growth in dividends. With the exception of Apple, investors are nervous about ascribing higher p/e multiples to growth stocks until the earnings really do come through. We will see in the next quarter how robust the earnings forecasts are. Investors have of course many more options outside of the traditional choice of bonds, cash and equities. They have the extended menu of private equity, real estate and alternative strategies. Recent revelations that some of the major investment banking houses are totally dedicated to short-term fleecing of their institutional clients encourages a much more long-term philosophical approach from the institutional investors.

In traditional terms studying Politics, Philosophy and Economics was seen as a sound grounding for a number of high flying careers. With the introduction of business studies, those privileged to be studying these courses are going to be well versed to help tackle the very challenging world we have created for ourselves. Economics are confusing us every day, good job figures, bad job figures etc are currently being absorbed with relative calm. I suspect the second quarter will set the mood for the rest of the year. We have poured so much money into the system to keep it afloat it is not surprising that some of that liquidity has found its way into the stock markets. Soon we will have to work out how we pay for it.

View from a desk top

“There is no such thing as a segregated account”. This is the conclusion Barry Ritholtz (of finance blog The Big Picture) reached on examining the entrails of the MF Global case. It looks possible that nefarious activity caused some of the MF Global client losses but Barry’s point is wider than MF Global. Even in the most plain vanilla account with the most carefully run bank, there is a counterparty risk. Investors often believe that a segregated account means the money is theirs, always, and is always recoverable – and that somehow there is no counterparty. Your bank may be in a fiduciary relationship to you but they are also your counterparty. This is all very low risk until the bank runs into trouble. At that moment, the precise nature of your counterparty relationship will become crucially important. Having funds in a segregated account will be of little comfort to account holders half way down the list of creditors when the bank goes bust, whether or not the account was on the bank’s balance sheet. This is not a call for investors to retrieve their cash and stuff it into the mattress – counterparty risk is simply a fact of life – but it is a call for investors to understand counterparty risk which, as investors in MF Global are finding, can be very difficult to unravel.

The complexities of counterparty risk are highlighted by the recent coverage of credit default swaps in the light of the Greek default. CDSs were sold as a tradable product (like a security) which could be used to insure against default including a sovereign debt (like an insurance product). They are therefore something of a hybrid between an insurance product and a security and their hybrid nature has been a major element in their growth; trading in CDSs has in itself been profitable for issuers who have also benefitted from the fact that they do not have to reserve for expected losses whereas the issuers of insurance policies do. For the issuing institutions, CDSs are better for the balance sheet. But the hybrid nature of CDSs should also give investors pause – the counterparty risk is commensurately more complicated. The trigger for a CDS to pay out is not a trading point or a verifiable event occurring but a ruling by the International Swaps and Derivatives Association as to whether the insured-against event has actually happened. The ruling
over whether Greece has or has not defaulted (and therefore whether the CDSs on Greece must pay out or not) is made by the members of the ISDA Committee. This Committee comprises 10 banks and 5 mega hedge funds (including Bank of America ML, Barclays, Goldmans, Citadel Investment Group, DE Shaw Group among others). Note that there is not a single representative of a central bank, regulator or exchange on that committee. Every member of the decision-making body is also, on some level, a participant in the CDS market. So for investors, their counterparty becomes the issuing body (who are incentivised to issue CDSs because of the balance sheet benefits) and the ISDA Committee (all of whom are participants in the CDS marketplace). Again, this is not a call for investors to retreat from this market but to understand who stands on the other side of their trade when the music stops.

Snapshot for the quarter

- In the US, in 1984 the median net worth of the over 65s was 10 times the median net worth of the under 35s. In 2009 the median net worth of the over 65s was 51 times that of the under 35s.