Tony Yarrow's Investment View
RISK & REWARD

Wise Funds

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In which we discuss the origin and meaning of the phrase 'risk assets', introduce the concept of 'reward assets', consider whether inflation is returning, and begin to wonder what might happen if it does

What on earth is going on?

Once again, the financial markets have failed to lie down. After the referendum last June, Governor of the Bank of England Mark Carney expressed deep concerns over the future path of the UK economy. He anticipated a sharp slowdown, possibly a recession, and announced lower interest rates and a further round of Quantitative Easing (QE) in order to ease the pain ahead. And yet, less than a year later, the UK economy appears to be performing strongly enough, and the domestic-orientated FTSE-midcap index hit an all-time high as recently as yesterday.

With all that is going on in the world, shouldn't asset prices be falling?

Either our economy and the corporate sector are in better shape than the experts are telling us, or else we are in the later stages of an enormous asset bubble, which may be about to collapse around us.

We are not sure which of the above explanations is the right one, and it may be that neither of them is. This article will begin by examining the recent past, looking at how it has influenced our thinking in the present, and where we might look for clues as to how things might unfold in the course of the next few years.

The post-crisis world

The defining characteristics of the financial world don't appear to have changed much over the last decade or so. Things like next-to-zero interest rates have become so familiar that it is as if the extraordinary has become ordinary. It is perhaps worth summarising some of these characteristics, just to remind ourselves that things weren't always like this, and may not always remain so.

The Global Financial Crisis (GFC) of 2007-9 was caused by excessive amounts of ill-advised lending and borrowing. One might have thought that the remedy for a crisis caused by excessive borrowing and insufficient saving would be to encourage more saving and discourage borrowing, by raising interest rates, but that course of action could have led to widespread bankruptcies and economic depression, so the authorities chose the opposite course, which supported borrowers and penalised savers, through a policy of ultra-low interest rates and QE. These policies have created the financial context in which we all live.

Savers have become used to receiving no interest on their deposit accounts and have been forced to seek alternatives.

Government finances have collapsed. Tax revenues have fallen, and costs have risen. Austerity, whose effects have fallen disproportionately on the less well-off, has made only a marginal difference. A decade and a half ago, our government debt was around 33% of the national income (Gross Domestic Product or GDP). Today it is around 85%, and still rising. Deteriorating public services are an ongoing feature of the post-crisis world.

Banks are more tightly regulated, and can't or won't lend except to the largest and (on the banks' definition) highest-quality borrowers. Peer-to-peer lending, as yet untested in adverse conditions, was born and is thriving in this environment.

Central bank policy supports not just economies, but financial markets as well. Today it seems that financial markets need to be healthy in order for economies to be healthy. The result is more intervention, not only in bond markets, but in other areas such as housing as well.

Investors appear to us to exhibit two over-riding characteristics, an insatiable hunger for income, and an enhanced fear of losing money. They are keen to avoid '**risk assets'**, which can be loosely translated as anything which they think might go down in value. Paradoxically, 'risk-free' assets such as German and Japanese government bonds have been bid up to such high levels that anyone who holds them to maturity is **guaranteed** to lose money.

Government bond prices have been so high, and their yields so low, that investors have looked for alternatives. Companies have found it easy to borrow money, at rates of interest only a little higher than the rock-bottom yields on government stock. Companies, particularly in the US, have used the money borrowed, not to develop their businesses through hiring and training staff, or buying plant and equipment or better software, but to purchase their own shares. This type of financial engineering supports the share prices, and increases the earnings per share on the remaining shares , as well as the executives' bonuses, which usually depend on increases in the per-share earnings.

Companies are also using their cheap borrowings to take over other companies.

Company final-salary pension schemes have been badly affected by the low income yields on government stock. Actuaries use government bond yields to calculate the rate at which they expect the pension scheme assets to grow, in order to work out if the scheme assets are sufficient to cover the pensions of staff whose life expectancy keeps on getting longer. This expected growth rate is known as the 'discount rate', and for UK company final-salary pension schemes it is around 2.8% today, much lower than the actual rate of growth of the assets. At this glacial growth rate, many schemes are deemed to have insufficient assets, and, in order to limit their losses, all UK companies have closed their pension schemes to new entrants. There is no longer such a thing as a final salary pension scheme in the private sector. Despite closing, and paring back benefits, most final salary pensions remain in deficit. This situation will continue as long as bond yields remain at today's levels, which are lower than they have been since the UK government first began to borrow money in the late seventeenth century.

These are some of the features of the financial world we live in today..

Risk Assets

The phrase 'risk assets' was coined during the crisis, and is now in common use. It is a catch-all for 'assets where your capital is at risk' - shares, commercial property, and most fixed interest assets apart from short-dated government bonds.

Most investors are naturally cautious, and aren't attracted by the idea of losing money, so a 'risk asset' doesn't sound like something that you'd immediately want to rush out and buy.

One might ask 'as opposed to what?' The phrase 'risk-assets' implies an opposite, presumably risk-free assets, and you might wonder what these assets are. Cash certainly isn't a risk-free asset. If your cash deposit is paying you 1.0% a year, and the rate of inflation is 3.0%, then the spending power of your capital is falling. If your deposit-taking institution fails, then your cash isn't risk-free either, should you have more on deposit than is covered by the government guarantee.

There is a helpful comparison between the market in financial assets and the motor insurance industry. Insurers use vast databases to work out how big a risk each one of us poses, and how much to charge us in premiums. They know that on the whole younger people have more accidents than older ones, and men more than women. A younger man is a bigger insurance risk than an older woman. Beyond these general rules, much depends on the car, and on the individual driver. Some younger men might be reliable and safe, while some older women (I used to work for one) might be atrocious drivers, constantly bumping into things and people (who were always at fault for getting in her way).

We too have much data available to us, and are free to choose carefully between those companies that we feel safe to invest in, and those we would rather avoid, and those where we may invest if we are paid enough to make the risk worth taking. We don't feel that lumping the good ones and the bad ones, the circumspect and the hubristic, the cheap and expensive together, and calling them by the collective phrase 'risk assets' is a particularly helpful exercise.

Reward Assets

Reward assets are a sub-set of risk assets. We all know what it feels like when we've found one. These assets have prices which can fluctuate, but are conspicuously well-managed, and generally exceed expectations. We are looking for a type of manager – dedicated, experienced, energetic, and not content with anything less than excellence. While working on good outcomes, these managers are aware of the many pitfalls and banana skins along life's way, and make contingency plans accordingly. They tend to under-promise and over-perform. There are risks, of course, but the risk that you have anticipated and planned for tends to hurt you less than the one you haven't. The assets they manage should always be the most highly valued in their markets, but they often aren't, because investors are often looking for something else. The investment markets aren't as efficient as the motor insurance industry. In our markets, we sometimes get paid the premium for a young male driver, when we're actually insuring a cautious older lady.

Everyone involved in the financial markets in the year 2007-9 was deeply traumatised by the events of those years, which we all remember as if they were yesterday. No one wants to repeat the experience of losing half the value of their portfolio in less than two years. We know that in a bear market – which could be just round the corner, the prices of good assets get dragged down with the bad ones. People often can't sell the assets they want to get rid of, so they have to sell the good ones instead, and their price go down with the rest.

But what happens after that? Bear markets are temporary, and afterwards prices recover. Reward assets always surprise you positively. After a recession, it turns out that they have picked up new work formerly done by companies that have gone out of business, they have been able to hire good people who've left firms or been made redundant, their margins are better as a result of competitors falling by the wayside, they have been able to acquire assets cheaply, and more often than not they emerge from difficult conditions stronger than they went in.

Reward assets are tucked away in the universe of risk assets. Investors who avoid the 'risk assets', avoid the reward assets as well.

Clever and intelligent investing

Is there a difference between being clever and intelligent as investors? We think there is. The difference may be easier to illustrate with examples, than to define, but perhaps it is that clever ideas are often time-limited, whereas intelligent ones are timeless.

Here are a few clever ideas. If you believe that economic growth in the emerging markets is likely to be stronger over the next few decades than in the developed world, you might want to look for companies with exposure to emerging markets. If you believe that the weak pound will encourage a boom in inbound tourism to the UK this year (as appears to be the case), you might be looking for retailers, restauranteurs and travel firms who might benefit from this trend. If you expect a recession, you might invest in accountants with strong insolvency practices.

However, this type of thinking only gets you so far. There are so many ways of being right and wrong at the same time. You may be right about the emerging markets, but in the short term, your investment might be scuppered by a nasty recession in those areas. You may have predicted the next recession correctly, but maybe in the event, the banks will decide to be lenient to their challenged borrowers, resulting in a very low level of insolvencies. In all cases, the opportunities may exist as predicted, but the company managements may be unable for one reason or another to take advantage.

We try to avoid relying on clever ideas when making investments. We are looking for assets that are sound, and above all well-managed, and not too expensive. We believe that this is the more intelligent approach. We don't know what the future has in store, but in our experience the managers of the reward assets are better prepared, and better able to cope with whatever challenges may arise, than their weaker peers.

We have been able to survive in a difficult environment by buying the 'risk assets' that no one else seems to want. There are still plenty of these to choose from.

Where do we go from here?

Inflation will either rise, or if it won't. If it doesn't, then the environment that we have become used to could continue for years to come. If it does, then we could be at a major turning point. We can't be sure, but incline to the view that inflation is more likely to rise than stay at its current very low level. This is for several reasons.

Commodity prices won't fall

The world uses many commodities, but the one we know best, and use every day, is oil. Between July 2014 and January 2016, the price of crude oil fell by three-quarters, from $115 to $27 per barrel (a barrel contains 42 gallons), before rising to its current level of $55. Today, the price of crude is roughly half where it was three years ago. Some commentators believe that the growth of the shale oil industry, together with the birth of commercial electric vehicles, have changed the balance of supply and demand for ever. This seems unlikely. World demand for oil continues to rise, and has accelerated since the price fell. Electric cars will make a difference, but not just yet. Meanwhile the Indians and Chinese who together account for almost half the world's population are buying petrol cars much faster than a few Westerners are buying electric ones.

Also, the slump in crude prices has put a squeeze on producers' profits, which has led to a slump in spending on new projects. The projects which have suffered are the big, expensive, long-term, deep-sea ones – the ones which won't be ready in a few years' time to replace production from the ageing wells we are using at present.

And the world needs infrastructure, the building of which uses a lot of commodities, including huge quantities of oil.

Demographics

The world's population continues to rise, at the rate of around 100,000 people every day, and living standards are continuing to rise. These facts aren't newsworthy in the way that tragedies and disasters are, but the lives of ordinary people continue to grow longer and more secure as time goes on. This extra consumption is inflationary.

Unemployment was at record high levels in the aftermath of the crisis, but has fallen steadily since, as employment has recovered to new record levels. High levels of employment tend to go with higher wage growth, higher demand for goods and services, and in due course, higher inflation.

Governments need inflation

The governments of the world's largest economies are all hugely more indebted than they were a decade ago. Most are struggling to reduce their deficits, the rate at which they borrow new money, to manageable levels. None have managed to balance the books, and the prospect of ever paying their debts down to pre-crisis levels is non-existent, so governments need inflation to repair their finances.

Is there a bubble in financial assets?

Probably. There appears to us to have been a QE-induced bubble in the government debt markets for most of the last decade. Prices of the highest quality corporate bonds, which are seen as 'the next best thing' are expensive too.

In the last year, prices have risen in other areas in which we invest, and are less obviously cheap than they were. We can still find value in commercial property, but we have had to look a bit harder than before.

Our favourite asset class continues to be shares. In the stock market, investors continue to show a preference for the highest quality names, for the companies perceived to be safest (the 'bond proxies') and momentum stories – in other words, investors like to buy shares whose prices have been going up. These natural biases continue to offer us opportunities. We can still find plenty of good, cheap companies, which other investors are avoiding for one reason or another.

Should the supply of value opportunities run out, though it hasn't happened yet, we believe that the correct response would be to adopt a more defensive, capital-preserving stance. In other words, we would be looking to 'park the bus' temporarily, as discussed in my last blog.

What happens to the financial markets if inflation rises?

The first casualty would probably be the bond market. Some government bonds already pay negative rates of interest, where investors are guaranteed to receive a return that's lower than their initial investment. Many bonds pay rates that are positive but very low, typically around 1.0%. At 1.0% inflation these bonds' real return is zero. At what rate of inflation does the return on government bonds become so unattractive as to trigger a major sell-off? Is it 3.0%, 4.0%, or some higher figure? We cannot be sure where the tipping point would come, but we can be sure that there would be one.

Rising bond yields would have a ripple effect on the rest of the financial markets, which could turn into a shock-wave if the increase in inflation were to be large and sudden. However, the government bond market has become so distorted that a slow or minor increase in inflation might have a positive effect on other asset classes, as investors switched into them.

Who wins and loses from higher inflation?

This is a large and complex subject, worthy of a whole blog to itself. For the moment, I will talk about four groups of people

The Government

It's hard to imagine that inflation could rise for anything more than a short period, without bond prices falling. Investors would require a higher rate of return on their bonds, which would mean the government would have to pay a higher rate on newly issued bonds.

However, the rate of interest on the existing bonds is fixed, so the Government would pay no more or less than before on its existing stock of debt. Our Government has used the benign conditions of the last few years to lengthen the maturity of its debt – they recently issued a 2060 bond, on which they will pay a fixed 4.0% rate of interest for the next 43 years. If they can get close to balancing the books, then all they have to do is to replace existing debt as it matures, and probably pay a bit more interest on the new issuance.

The big win for them, though, is that inflation will erode the real value of their debt. If you owe £ 1.6 trillion, 4.0% inflation reduces the real value of your debt by £ 60bn a year, equivalent to the current deficit. As prices and salaries rise, VAT and income tax receipts go up, but the outstanding debt remains fixed.

Bond investors

Bond investors are the obvious losers from higher inflation. The payments they receive are fixed, and the faster inflation rises, the faster the purchasing power of their fixed income falls. If rates of interest ever rise back to pre-crisis levels, how investors who bought fixed rate bonds at 2% and 3% yields are going to wish that they'd left their cash on deposit! And when the bonds mature, their values will have shrunk with inflation.

Companies with pension fund deficits

These companies should benefit from higher inflation. The discount rates used by the scheme actuaries to calculate the amount of funds needed to meet liabilities will rise with bond yields, the deficits will disappear as if by magic, and the companies will be released from the onerous extra payments they have been burdened with for the last few years.

Families

There will be winners and losers, depending on circumstances. It will help to have a fixed-rate mortgage when inflation returns, preferably one that's fixed for a long time. It will help to have an income that will rise with inflation, or preferably faster. In other words, it will help to have bargaining power.

As in so many other situations, hardship falls disproportionately on those least able to withstand it. We are having a taste of inflation at the moment, as the sharp fall in the value of the pound last year has caused a jump in the prices of imported food and power. These items use up more of the after-tax incomes of the less well-off, and so hit them harder. It may be no coincidence that the total of UK household debt, which had stayed steady at around £ 1.45 trillion since late 2008, has begun to rise, and is now £ 1.52 trillion. The number of debtrelated enquiries at Citizens' Advice Bureaux has risen recently (source – The Money Charity).

Higher interest rates might lead to falls in the values of houses – which would be an obvious disadvantage to some, but a benefit to others as it would make buying a first home easier, and perhaps make the overall market more liquid and less dysfunctional than it has been in recent years.

Conclusion - looking backwards and forwards

The early part of 2017 has been kind to the Wise funds, particularly TB Wise Income, which has made a total return of around 8.6% so far. This pleasing result has been largely driven by the 30% of the portfolio which is invested in UK smaller companies. Our large company shares, meanwhile, have been sluggish.

In the last three years Wise Income companies have received four successful take-over approaches, of which two, Lavendon & WS Atkins, have come in the last few months. One of the bidders was Belgian, and the other one Canadian. From the viewpoint of an overseas investor, UK companies are cheap, courtesy of the weak pound. Money can be borrowed in almost unlimited quantities in the bond markets at extremely low rates of interest, which may not continue to be the case. Conclusion - there will never be a better time than now to take over UK companies.

We would never dream of investing in a company in anticipation of a take-over approach. That is just the sort of clever thinking we know we aren't any good at. But this train of thought makes us just a bit less willing to take profits in companies whose shares have risen significantly, than we might have been otherwise.

We continue looking for **reward assets**, ones that we will be happy to own for prolonged periods. We have found and invested in several new ones already this year, and the search continues.

I would like to wish you a happy and peaceful Easter.

As ever, I look forward to your comments and questions.

Tony Yarrow

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Please note – this blog contains the personal opinions of Tony Yarrow. It should not be construed as financial or investment advice.