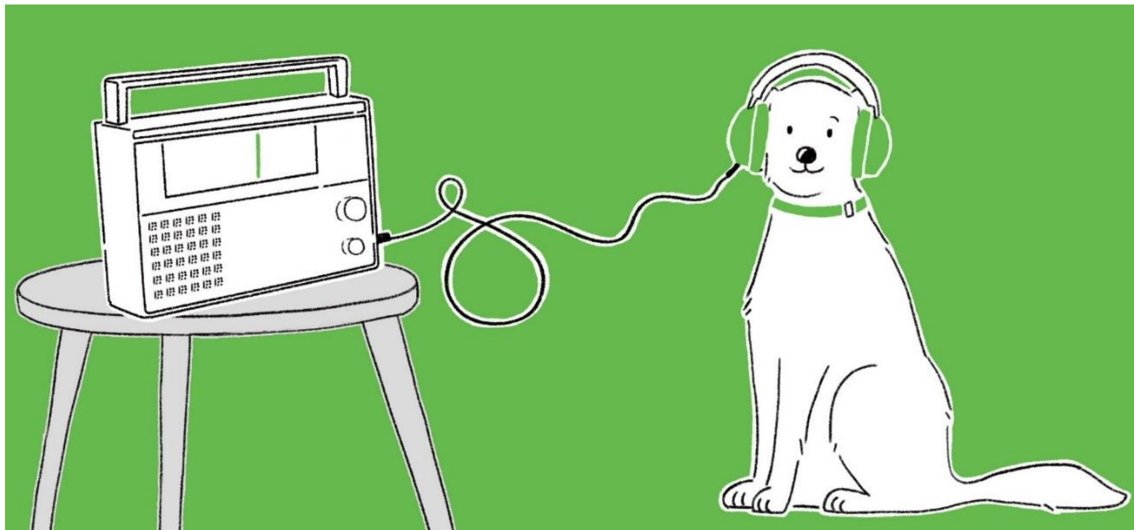
Ruffer Radio

Episode 5 – A view from the bridge



First published at ruffer.co.uk/rufferradio, 8 January 2021

Rory McIvor

Welcome to Ruffer Radio, a series of podcasts in which we'll be exploring the investment universe, and sharing our interpretation of what's going on. 2020 was a year to exhaust all clichés, just about everything was unprecedented including use of the word unprecedented. We now find ourselves on a bridge from one year to another, hoping for safe passage but without certainty of what we'll find on the other side. Today, we'll provide a view from that bridge. We'll look back over the course of the covid-19 crisis, share our insights into the ongoing recovery and look forward to some of the key challenges facing investors in 2021. I'm joined by Investment Director, Duncan MacInnes, and Fiona Ker, a Senior Investment Associate at Ruffer. A very warm welcome to you both.

Duncan, let's start by looking back over the last year. How would you summarise 2020? Clearly, some parts of the market did better than others but were there any particular strategies which came up trumps?

Duncan MacInnes, Investment Director, Ruffer LLP

There's a famous saying in boxing that it's the punches you don't see coming which knock you out, and in 2020 there were punches flying in every direction. Speaking broadly, most strategies had quite extreme periods of strength and weakness. For example, the US market may have closed the year up 16% but it got there via -30% in March. If we look at the totality of what happened in 2020, what is remarkable, I think, is that covid-19 just served to accelerate a whole bunch of trends which were already in motion, such as the digitisation of everything, an ever increasing proportion of economic activity and leisure time moving online, and as the venture capitalist Mark Andreessen observed a few years ago, software was going to eat the world and he looks more right every day, because covid was probably the single fastest accelerant of

technological adoption, ever. Almost every business in the world had to bring forward five or ten years' worth of plans into just a few weeks. It was adapt or die. As for the Ruffer investment strategy, what we try to do is build an all-weather portfolio. We stress test that portfolio against every risk that we can think of and yet a pandemic and a global synchronised lockdown were not one of the things that we modelled for, so, it's been a great vindication to have had a good year in spite of that, because it shows that we built a portfolio which was truly fundamentally robust.

Rory McIvor

And Fiona, what did this acceleration of trends mean for asset markets?

Fiona Ker, Senior Investment Associate, Ruffer

Well, it meant we saw an even greater disparity of performance within equity markets. We had big tech, the covid stay-at-home winners benefitting from the pandemic, and share prices soared. Meanwhile, other sectors such as physical retail, commercial property and travel, of course, really, really suffered. If you had taken a sort of sleeping beauty style nap throughout 2020, you could have awoken at the end of the year and being forgiven for assuming that things had continued on as was in 2019, in aggregate markets went up, and the tech sector continued to be the best performing. But, under the bonnet, we actually went through several distinctly different phases throughout 2020. We had this very strong start to the year that was cut short by a panic stricken sell-off, and then once we saw central banks and government step in after the virus struck, there was a liquidity fuelled rally that lasted from April all the way through to November when we had a vaccine announced, and with that came even more positive news about the hopes for a reopening of the economy and the market shifted, they rotated and we saw a completely different section of the market leading the performance into the year end. So, all in all, a pretty challenging year for investors to navigate because each of these phases demanded a significantly differently positioned portfolio to do well, but overall I think coming back to what Duncan was saying at the start, what most people will find the most surprising, I think, is that through a severe global recession, most assets made money, and that's quite a difficult thing to reconcile with the lived experiences of 2020.

Rory McIvor

So, this time was really different and certainly different to crises in recent decades. Fiona, could you shed some light on how and why this crisis has been like no other.

Fiona Ker

Well, I think firstly it's not normal to expect the equity markets would rise in a global economic crisis, so that's one thing that we took away from 2020. Duncan mentioned that it's the punches you don't see coming that really get you and 2020 started off with this kind of one-two-punch combo. We had the pandemic and shortly after, just to add to the crisis, we had an oil price war; so I'm not sure anybody could've reasonably predicted what the outcome would be, and with the benefit of hindsight, we can say that it was a year of extremes. If I give a few examples, we had a market sell-off in March as we've mentioned but stocks at the peak of that sell-off were more than 30% below recent highs, and that's a more violent bear market than we've seen since the 1920's and the Great Depression. Secondly, for the first time ever, we saw oil trade at negative prices because demand evaporated, producers simply had nowhere to store their supplies. And then lastly, the job losses that we've seen throughout 2020 have dwarfed any historical

comparison, and even after quite a significant recovery in the US, the levels of unemployment there are only just back to the trough scene in the global financial crisis.

Rory McIvor

And to continue with your boxing analogy from earlier, when the economy was on the ropes, the authorities', central banks and governments, response to the crisis was quite remarkable.

Duncan MacInnes

It was. It was indeed. Government spending exploded everywhere. Previously, unthinkable things happened on a regular basis, the furlough scheme, Donald Trump mailing out cheques to citizens, deficits reached levels only before seen during the war time, and of course total debt reached a new all time high. It was our view before the crisis, that the world was stuck with the systemic problems of too little growth and too much debt, and both of them have gotten significantly worse. Yet despite all of that, may of the extraordinary things that have happened in markets since March, have been to the benefit of asset owners, and they certainly have a sort of frothy feel to them, so it's like we live in a world of two extremes, the real economy which has been gravely wounded, and then a rose tinted utopian liquidity fuelled world in the financial economy.

Rory McIvor

And, Duncan, how has that polarisation manifested in practice?

Duncan MacInnes

It's just very incongruous I think, that we have an IPO boom, this SPAC frenzy, retail day trading, returning to the mainstream-

Rory McIvor

Sorry to interject, Duncan, many people I'm sure will be familiar with an IPO but could you just explain exactly what that is, and could you also confirm that a SPAC has nothing to do with the character from Star Trek…

Duncan MacInnes

Well, I would not rule out a Star Trek SPAC in 2021. So, an IPO is an initial public offering which is when a private company comes to public markets for the first time. A SPAC is a special purpose acquisition company which is a bit of alphabet soup, but it's when someone raises a blind pool of money with the objective of buying an as yet undisclosed company, and that usually comes with little information, that opacity, and a lot of upfront fees. But zooming out of it, other signs of froth in the market are some of these 'zeitgeisty' stocks trading on remarkable valuations whilst simultaneously the real economy is still in a deep recession, and is on life support. Perhaps my favourite example of this wishful thinking or suspension of disbelief that's going on in markets, and the tolerance of shall we say ambitious storytelling by companies, is the next gen electric truck SPAC which is a phrase you couldn't have said a year or two ago, which had a $30 billion valuation after the share price rose 800% between March and October, yet the business model for that company was really nothing more than the idea of an electric truck which they literally rolled down a hill in the promotional video because the truck did not have an engine. And these sort of crazy things that have been happening today also happened

back in 1999 at the top of the dot.com bubble, companies raising money pre-revenue, so before they have any sales or even, my favourite, pre-idea which is as absurd as it sounds. So, it just all kind of adds up to show what was one termed the extreme brevity of financial memory. Nothing makes people forget the risks that they're taking faster than the stock market going up or seeing their neighbour get rich.

Rory McIvor

And rolling cars down a hill is certainly a creative solution to the challenge of reducing vehicle emissions, although I'm not sure that soap box racers are the long term solution to global logistics. Duncan, that's a fairly comprehensive stock take on 2020. So, let's bring it forward to today - what does the recovery look like now?

Duncan MacInnes

In the April 2020 episode of Ruffer Radio, I had the privilege of speculating on what shape the recovery might take from that uncertain point, and I mentioned W, V, U, L, pretty much every letter of the alphabet you can think of apart from K which just goes to prove that economic forecasts exist only to make astrologers look respectable because, now, today it seems pretty obvious I think that we're in a K-shaped recovery, that means winners and losers, because the unique shape of the covid crisis and the recession that's gone alongside it has meant that some industries have thrived, and others have suffered, and that's been reflected pretty quickly in the stock prices of a lot of companies as Fiona mentioned earlier.

Fiona Ker

I think the interesting question for 2021 is though how long can a K-shaped recovery continue. We went through 2020 using this mantra that we are all in this together and that was very heart-warming, but really as we're seeing now it was totally inaccurate. There was a huge dispersion in people's experiences, those who lost their jobs and had to spent lockdown worrying about financial security, compared to those who were able to take their laptops home and more or less continue with life as it was, albeit with a little less social interaction. And this winners/losers dynamic, it has economic, social and political consequences, it has cost significant numbers of jobs and hollowed out our economy, and it's also exacerbating a pre-existing issue of inequality. So I think that what we might see going forward is government stepping in to address this issue. And as Duncan mentioned, we've already seen them go further than they have in previous crises in terms of the income support that's been offered but there's still potential for a lot more to come down the road. And in some ways that's just an evolution of policies that were already in the making. Here in the UK, we had this idea of levelling up, that the conservative government included in their mandate, so, we expect to see more of that going forward.

Rory McIvor

So by the signs of that, the K-shaped recovery is not okay, it will crack. Duncan, why does this matter from an investment perspective?

Duncan MacInnes

It matters because governments have a habit of bending to popular opinion, and there are a lot of disenfranchised people today as a result of covid-19 who are looking for someone or

something to blame their misfortune upon. Capitalism, big business, the 1%, they all seem to be probable targets who will be required to pay their fair share, and that is a fertile environment for these percolating ideas of wealth taxes and such things that we started to hear about.

Rory McIvor

So what options do governments have to address these ballooning deficits, clearly increasing taxes is one option but do you think that that will work?

Duncan MacInnes

Unfortunately, because I don't make economic policy, it's not really relevant if I think it will work or not but what matters is what will happen and it really looks like going after big business and the rich is politically popular, but the truth we think is that tax hikes will not touch the sides. The UK national debt is £2 trillion, the US national debt is about $26 trillion, we think that those debt levels are simply too big to be repaid through taxes alone in the UK. You could increase everyone's income tax by 1% which would of course be very unpopular and it would only raise about £5-6 billion so it doesn't dent the debt mountain. The whole situation reminds me of the movie Jaws where the guy sees the shark for the first time, and he turns around with horror on his face to the captain and just says we're going to need a bigger boat.

Rory McIvor

So, Fiona, how does the vaccine fit in to all of this? Could the vaccine close the arms of the K?

Fiona Ker

I think the vaccine has a big impact on the outlook for 2021 and beyond. If we can resume in person activities sooner rather than later, it's certainly going to be of benefit to vast swathes of the economy. But in terms of closing the arms of the K, I think the vaccine is only half the story here. We've already been talking about all the extraordinary government spending and the central bank support that we saw through 2020, and the way we think of it is policymakers were trying to stop the financial and economic clock to buy time to fight the virus, and while the economy was on pause, all the money that was pumped into the system was essentially, to use Duncan's phrase, a form of life support. But what we note is that with the vaccine now coming out, central banks haven't made any adjustments to their policies, and governments across the board continue to deliver and promise ongoing fiscal spending, and it's the combination of a vaccine, and the reopening of our economy with continued fiscal and monetary stimulus that could really fire up the economy, and we hope help to close the arms of the K.

Rory McIvor

And Duncan, what are the historical parallels here? I mean, are there any?

Duncan MacInnes

Not many. Thankfully, pandemics have been few and far between, that there was the Spanish flu in 1918, and interestingly for a parallel, after that, came the roaring twenties, that the combination of the first world war plus the pandemic meant that people have put their lives on hold for a very long time, and it's entirely possible that something similar has happened during covid—delayed weddings, delayed house moves, cancelled holidays, etc. Now, that doesn't downplay the very real damage done to economies and lives by the virus, but it is a ray of light to

the people whose businesses and jobs manage to make it to the other side. And in terms of thinking about the future, in his book, *Atomic Habits*, James Clear argues it takes 66 days to form a new habit. Well, we've all been locked down for 250 days and it looks like we probably have a hundred more in the future, so it seems likely that some things will not revert to whatever normal was, and there will be some permanent changes to people's behaviour and habits.

Rory McIvor

There seems to be an almost consensus view that the stimulus that we've seen to date will continue, if not indefinitely, then certainly for some time. Fiona, do you think the market is taking this for granted?

Fiona Ker

Well, of course we know Ruffer has a reputation as being somewhat contrarian but on this occasion we would agree with that consensus. There's so much mutual desire for more stimulus, from voters, from politicians, it's really not clear who would argue against it, and worth remembering as well that in the UK the current government was elected on a mandate of spending. There's lots of issues in society for which the government now seen as the solution, in particular thinking about climate change and inequality as I mentioned earlier, so essentially our view is that this is a new regime for the political economy, it's one in which governments are far more likely to do too much stimulus than they are to do too little.

Rory McIvor

And so looking ahead then, Duncan, what else do investors need to be focusing on as we inch our way through 2021?

Duncan MacInnes

The easiest way to answer these questions is usually by listing a bunch of risks and there's always lots of them out there. Every year, investment banks put out these global outlook documents which have dozens of risk and opportunities. But the funny thing is, is that if you went back and looked at them all, the 2020 outlooks from last year, none would have mentioned coronavirus, and it just so happened that last year, that was the only thing that mattered. So the point I'm trying to make is that nobody really has any idea of what's going to happen next and that is more applicable today than usually, but, just for one second, let's imagine what an optimist might say about the future. We've just had this quite unique shock to the global economic system, and for the most part, listed companies have weathered the storm, adapted and survived. Now, if they can do well in that environment which they have, then surely they have proved that they can survive almost anything, furthermore some of their smaller competition has gone by the wayside, and these big companies have had a great excuse to cut cost and rationalise. So investors usually attach what is known as a risk premium to stocks because they're riskier than bonds or cash, so we should be compensated for that. But maybe 2020 has shown us that that just isn't true, it's not the right way to look at things, maybe the risk premium for a resilient, adaptive, responsive real asset such as partial ownership in a business via an equity should be much lower. And if that's true, if you believe that, then stocks look attractive relatively to the paucity of alternative because they yield on cash and on bonds, it seems likely to stay low long into the future.

Rory McIvor

And in this context - with yields low and in many cases negative - conventional bonds look like a real liability.

Duncan MacInnes

Yes. So somewhat provocatively – I've been asking clients just remind me why is it that you own conventional bonds, because I think it's the most important question that they should be asking themselves today. Conventional bonds have been the cornerstone safe asset of investor portfolios since at least the creation of modern portfolio theory in the 50s, and for almost all of that time they've done a great job delivering strong total returns, and really importantly, acting as a portfolio offset, so they've gone up at times of stress when risk assets and the portfolio have fallen. But from here, right now, with interest rates and yields as low as they are, it's hard for me to see why anyone would want to own them. I don't see what they add to your portfolio.

Fiona Ker

It's probably worth calling on an example here. The German bund is deemed to be one of the safest assets in the world, had you held bunds from 2019 and through the covid crash, you lost money. So a safe haven conventional government fund managed to fall in value through the sharpest and deepest recession in recorded history, so that gives you a bit of an idea about the starting valuation perhaps. I mean, as Duncan was alluding to, it's generally accepted that bonds are this perfect complement to equities in a portfolio because they've tended to offset falling equity markets, but from this starting point with interest rates at ultra-low levels, we have $18 trillion of negative yielding debt out there, and we're entering this period we think of increased fiscal stimulus, so it just really doesn't feel like a time that you want exposure to conventional bonds offering you little or no yield but exposing you, unfortunately, to interest rate and inflation risk.

Rory McIvor

So you've described this sort of existential crisis for bonds, and it would appear that traditional balanced portfolio, 60-40 portfolios, could have a very hard time over the coming years. Duncan, could it be a lost decade for 60-40 and passive portfolios?

Duncan MacInnes

So taking a step back to remind everyone that a 60-40 portfolio is 60% stocks, 40% bonds, rebalanced every month or quarter, and that idea has been core to the wealth management and financial planning industry for decades, and for something so simple, it has been remarkably effective. So for us to sit here and call the end of something that's been so fundamental to so many investors' portfolios is brave or foolhardy, but I cannot see how it works out well form here or works out anything like it has done in the past, and the reason for that, the problem, is that today both assets, the stocks and the bonds look very expensive relative to history, and that situation has always led to lower longer term returns.

Rory McIvor

So what does this mean for the traditional balanced portfolio?

Duncan MacInnes

Our peers at GMO have done some really good work on this topic and they've shown that there have been six separate periods of around a decade in duration where a balanced portfolio produces zero real return, which is pretty worrying. Today, we know that a ten year bond in the US yields 0.9% and the UK yields 0.2%. Now, bonds are a mathematically bounded asset class. You know with certainty that the ten year return will be exactly those yields and nothing more or less. So, if 40% of your portfolio is generating less than 1%, then you know that the equity bit of your portfolio will need to work extremely hard to get to a decent return overall. So let's just say that your target return is 8%, that would mean that your stocks need to earn more than 12% per annum for you to hit your overall return target. It's just hard to see how that happens when the dividend yield is only two or three, therefore I would propose that the intellectually honest thing to do, although it would be unpopular, is to lower expected returns for conventional portfolios, maybe by a lot.

Rory McIvor

That's a good bit of mental arithmetic for the parents who now find themselves home-schooling as well, a bit of extra practice there. It feels like the end of an era, certainly for bonds as you've mentioned. Duncan, has there been a prevalence of bench marking that's left investors structurally focused on the wrong areas.

Duncan MacInnes

Yes, I think so. I mean, Jonathan Ruffer coined this phrase years ago, the 'tyranny of benchmarking', because he observed that our very inward looking industry is obsessed with relative returns and benchmarking. And some would say, well, what else can you do to measure success? What you could do is focused on absolute returns, not relative outcomes, and you could start with a blank sheet of paper and only own assets which you think are attractive and have investment merit, regardless of who else owns them, and regardless of what their benchmark weighting is and that's what we do. Today, due to factors such as performance, size, liquidity, so many investor portfolios look the same, they've become increasingly homogenised and the entire investing world seems to be heavily invested in the same few trades over with the US, over with technology and investment grade bonds. And what we suspect the problem is, is that our industry has always been reactive and chasing what has been working which is a little bit like driving by looking in the rear view mirror. And so, if you believe our premise that the next decade is going to be materially different to the last one and we think that's quite likely then the portfolio that has worked and all these other people are invested in may not be fit for the future.

Rory McIvor

Duncan, that's a fairly holistic view of what investors can't or shouldn't do going forward, but let's turn to what investors can do in this regime. Fiona, what do you do for safety when everything safe is dangerous because it's expensive?

Fiona Ker

That's a toughie. We've been looking at ways of getting on the other side of some of those consensus overweight trades that Duncan mentioned. But it's worth pointing out that the types of protected investments that we've put in place are esoteric and in isolation at least certainly wouldn't be considered safe. They're not the one stop shop for investor portfolios that the

conventional bond once was. The way that we found protection or safety is by betting that corporate borrowing costs would spike in a crisis. That proved to be right and we managed to make quite a lot of money from these investments in March 2020. We've been talking about a corporate borrowing mania for a few years now and even from here it seems far from over. In most recessions, the level of debt rises as does the cost of borrowing, and what was really interesting during this crisis is that the central bank intervention into the bond markets has actually brought down the cost of borrowing again, and for us, if anything, it creates further opportunities because arguably the market's now even more distorted and mispriced than it was pre-covid.

Rory McIvor

And we've witnessed a scramble for genuinely uncorrelated alternative assets, so called diversifiers. This dash for alternatives has included Chinese assets, crypto currency, other emerging market stocks. Duncan, are investors right to venture out like this?

Duncan MacInnes

I'm not sure if they're right but I can definitely understand it. The world is suffering from a dearth of safe haven assets and there's a lot of liquidity sloshing around looking for opportunities. Also I think people sense that the portfolio role of government bonds is dwindling as we've discussed but they don't know where to go next, and this whole quest for new asset classes makes me think of the joke that if you opened your mind too much, your brain might just fall out. It's a little bit like if you go looking for new planets in the solar system, if you lower the bar enough, you'll probably find some and upgrade an asteroid to a planet. But undeniably, the current macro-economic environment is extremely challenging, negative interest rates, extreme monetary policy, ballooning public debt, dissatisfaction with government and institutions, we all know the long list, and they combine to foster a great deal of uncertainty. But despite that, institutional investors have returned targets to hit, and they have no clear way to meet them in conventional asset classes. So, consequently, the industry faces this acute shortage of diversifiers, and at a time where it feels the need to take ever more risk and get ever more creative to achieve its return targets, and my word of caution to these intrepid investors is the old axiom that more money has been lost reaching for yield than at the point of a gun.

Rory McIvor

A stretch or starve mentality. So there's this burgeoning interest in other stuff, infrastructure, venture capital, carbon credits, cryptocurrencies as we've mentioned, private credit and asset back lending, Fiona, how are Ruffer thinking about this search for alternatives?

Fiona Ker

With my optimist hat on, I think it could be really positive for Ruffer because we have always had a slightly different approach to much of the rest of our industry, in that we have… all of us sought genuinely diversifying investments for our portfolio, and going forward it's possible that this move into alternatives will eventually turn investor attention towards the likes of gold and inflation linked bonds which are already sizable positions in the Ruffer portfolio. And those are two of the assets that we hold because they protect real purchasing power and we think we're entering a period where we could see a little bit more inflation than we've been used to seeing over the past few decades.

Duncan MacInnes

We have a 25 year history of using unconventional alternative protections in our portfolio. That was the Yen and the Swiss franc back in 2008. And more recently it was volatility calls and credit protection in March 2020, and our thinking is always evolving in the spaces Fiona just alluded to. Ideally, we would make a small allocation to an idiosyncratic, unconventional asset class which brings something meaningfully different to the portfolio and it's behaviour. I said at the start that what we tried to do is build an all weather portfolio, and when thinking about that we try to take lessons in creative diversification from the hydra in Greek mythology. Now, the hydra had many heads, but if you chopped one off, two more would grow in its place, and because of that it was anti-fragile, it strengthened in adversity, and we are constantly on the lookout for assets or asset classes that add antifragility to the portfolio, and that add a different flavour of protection, some diversification to the gold and index linked that we think will be the most crucial for the world that we see coming.

Rory McIvor

Describing the beheading of the hydra as creative diversification, Duncan, I think is full use of your poetic license. Now, just to finish up, is it always to the advantage of an investment manager to be contrarian?

Duncan MacInnes

No. There's absolutely no point being contrarian just for the sake of it. Citigroup released some charts a few weeks ago which showed that 2020 was the worst year for contrarians ever, so, like we said earlier, covid just accelerated a whole bunch of pre-existing trends so it was good for momentum strategies. The consensus actually is right most of the time but the consensus is often dangerously wrong at the big turning points, and that usually ironically is when it feels most right and most obvious that the consensus is correct, and there are just countless examples of that through history. To turn the question around a little bit, James Grant said that the art of investing, is about having everyone agree with you but later and that, although simple, really sums up the absolute essence of investing - to have a differentiated view from other participants and have the rest of the world come to realise that you are right, and I think that is why finance attracts so many egomaniacs.

Rory McIvor

Present company excluded, I hope. Duncan and Fiona, thank you so much for your time. And thank you for listening. For more on Ruffer and how we think and invest, visit ruffer.co.uk.

Past performance is not a guide to future performance. Views expressed in this podcast are the views of Ruffer LLP. They do not constitute as investment research or advice, and may be subject to change. Ruffer LLP is authorised and regulated by the Financial Conduct Authority.