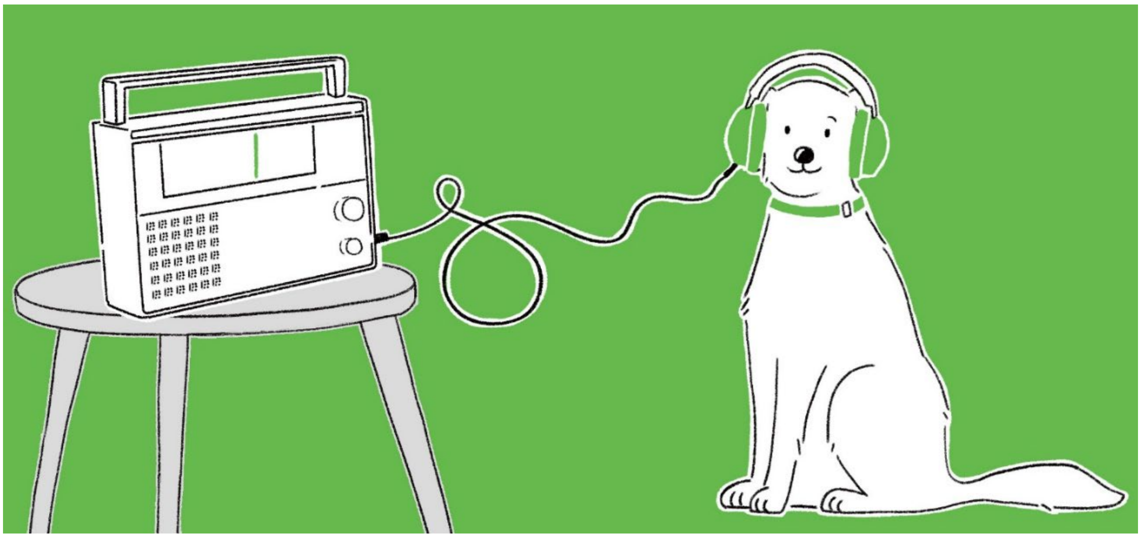
Ruffer Radio

Episode 21 – Ugly ducklings



First published at ruffer.co.uk/rufferradio, 17 April 2024

Rory McIvor, Director – Markets and Communications

Welcome to Ruffer Radio, a series of podcasts in which we explore the investment universe and share our interpretation of what's going on. Coming into 2024, it was clear that investor sentiment has turned decidedly bullish. Equity markets had a very strong first quarter to this year, and that's on the back of a strong 2023. The Ruffer portfolio today certainly isn't a consensus portfolio. In fact, it's a portfolio of ugly ducklings. By that we mean that we own some very unloved assets in the portfolio, but crucially, assets with the potential to provide excellent returns as conditions change across markets. Today I'm joined by Fund Manager Duncan MacInnes, who talk a little bit about recent performance and dive into those assets that we own in the portfolio, why we own them, and how he expects them to perform across the range of market conditions. Duncan, a very warm welcome and thanks for joining.

Duncan MacInnes, Fund Manager

Hi Rory, thanks for having me.

Rory

So let's just start off at the beginning of 2024. What was the market setup looking like when we came into January?

Duncan

So, coming into the year, we had an odd scenario where in our assessment, bonds and commodities were pricing in a recession, but equities were pricing in sunshine and rainbows. And that had driven this weird dynamic where in Q4, stocks and bonds had both gone up, which investors loved, but they went up for reasons that were completely incompatible. So, our way to play that coming into this year was to have about 15% of the portfolio in commodities for that scenario, where growth might surprise positively. But to issue those other two asset classes having a low duration in bonds and a low equity exposure, because neither of those assets to us looked like they offered asymmetry.

Rory

Fair. Duncan, I want to go straight into then how the Ruffer portfolio has performed over the course of the last few months, performance seems to have ticked up in recent weeks.

Duncan

Yeah, there's a little bit of momentum behind our investments. We've had five or six consecutive weeks of positive performance. Two swallows, or a number of swallows, don't necessarily make a summer, but I think that does reflect a shifting in how the world is being perceived by investors. So, yeah, we're about flat year to date, which is better than it was.

Rory

I think it's a single swallow a summer does not make. But neither of us clearly know exactly what that little aphorism is. Duncan, let's go in to talk about what you do own in the portfolio where some of those recent positive returns might have been coming from, and these structural positions that you're bullish on. Gold is one of them. But commodities generally, you mentioned as well.

Duncan

Yeah, so we've got exposure to commodities generally. So copper, oil, uranium, and then precious metals we can maybe talk about separately. But the copper and the oil are in the portfolio to capture that economic growth that we talked about. And also, they're deeply unloved by investors so, one of the things that we look at are sentiment or investor positioning surveys. And they would suggest that at the start of this year, investors were as underweight commodities as they had been since the market bottom in 2009. So everyone was all in on bonds and didn't own commodities. That's improving a little bit over the course of the first few months of the year, but we would think has much further to go because commodities play a really important portfolio role in terms of capturing exposure to economic growth, but also diversifying and offering an inflation edge.

Rory

And then on the precious metals, is it gold bullion that you own? Is there a mix of bullion and miners? How are you thinking about it?

Duncan

So Ruffer have almost always had some exposure to gold, and usually that's a balance of gold or gold mining stocks. Today we actually have a mix of gold mining stocks and silver bullion. So we've got about 9% of the portfolio across those two. But I think that they're different ways of playing gold. I would think about it as a gold and precious metals allocation, because if you had one asset to express Ruffer’s long term view of the world, which is concerns around financial stability, concerns around inflation and inflation volatility, and the idea of financial repression, gold would be it.

Rory

So you think of them, Duncan, as one precious metals allocation. But clearly they are quite different in some ways. And silver is actually a lot more useful than gold. Silver has industrial use as particularly useful in the electrification of pretty much everything. Presumably then, that's a pretty serious tailwind in terms of demand and supply.

Duncan

Yeah, it's an additional angle to silver, the fact that it's used in a lot of high-end industrial processes or industrial goods. But I think really the attraction with silver in the portfolio is that it's turbocharged gold with that cyclical industrial kicker that you just mentioned. So historically, what tends to happen is that when the gold market moves, which it has been doing quite dramatically in the last few weeks, silver tends to move a little bit later, but go much further. And that's quite similar to the gold mining equities, which tend to have a beta of two. So do twice as much as gold when they get going.

Rory

I think one of the key points when talking about this commodity exposure broadly is that this is not necessarily just a protection play. Right, so it's actually helping the portfolio be a little bit more balanced even in the conditions that we have at the moment, where equity markets are generally ticking along and have been quite strong and there isn't that dislocation.

Duncan

Yeah, that's a good way of thinking about it. So gold, of course, is a safe haven asset. It historically does well in crises. It should protect you from inflation. But right now gold is going up, I would say in shorthand, because governments are being incredibly stimulative. So the stock market is doing well because the government has done, the US government in particular has done much more stimulus than they previously planned, running large deficits and so on. That's good for the economy, but it's also a sort of form of fiscal incontinence. And gold does very well in that scenario. So, weirdly, gold and stocks are going up at the same time right now, but it sort of makes sense if you think about it through that lens.

Rory

Duncan, before getting into the yen and currency positioning generally, I just want to speak a little bit on the other potentially more esoteric protection elements to the portfolio. What's the nature of the derivatives, the insurance type protection that you've got at the moment.

Duncan

So I think this comes back to your sort of mentioning the ugly duckling, the protective toolkit which served us so well in 2020 and 2022, very much the sort of ugly duckling of the portfolio at the moment. So we have a range of things that we can us, we have credit protections, which are betting that credit spreads will widen. The cost that companies pay to borrow will rise. We have some positions in volatility, that market volatility will rise and we have puts on the equity market. So these options appreciate in value if the stock market falls. The commonality across all three is that they do well when markets struggle. Hence the protective element. But also right now is that they are all historically cheap.

Well, actually, volatility has gone up a little bit in the last couple of days, but volatility was until earlier this week at levels that we hadn't seen since before the covid-19 crisis. Credit spreads are as benign as they were before the financial crisis. And maybe the most dramatic is the cost of buying out of the money put so bets the stock market will fall by a relatively large amount is the cheapest it's been in several decades. So what that adds up to is a picture that risk appetite is very high, investors are relatively complacent and they don't want to pay to protect the downside. And of course that's great because that means we can buy lots of protection against the downside, something we're quite worried about given elevated market valuations. And we don't have to pay that much to do it. And if it works, they'll punch very hard for us.

Rory

So let's move on then to the yen. It's a position that you've had in the portfolio for quite some time to date the critic would observe that it hasn't worked. So Duncan, what's the continued rationale for holding it? And in what size do you hold the yen?

Duncan

It has hurt the portfolio up to this point. It cost us a couple of percent last year. It's probably cost us another 1% this year. And that's what happens when something goes from the cheapest it's been in 20 years to the cheapest it's been in 40 years. But from here, I think the asymmetry is sort of undeniable. Now, we do have a long history with the yen. We used it effectively in the financial crisis. We carried a big exposure into that crisis, and the yen rose by 48% against sterling, which was very helpful to the portfolio then. And we see it playing a similar role today, Jonathan Ruffer is on record saying that he thinks the yen is the most attractive investment he has ever seen. And with the greatest of respect to Jonathan, he has been around quite a long time, so he's seen quite a lot of potential investments. And he did also once say that if you ever have a view about a currency, you should go into a darkroom and have a lie down, because currencies are notoriously difficult to predict. But if you get up from that lie down and you still have the view, and we do, then you should do something about it. So we've got about 10% of the portfolio in the yen today. That's a little bit less than we had at the turn of the year, but it's supplemented by a small option position, which has the potential to become quite material on top if the yen appreciates.

So it's a big position. It's not quite as big as it was earlier in the year, and that's because some of the imminent catalysts that were excited about have come and gone. But the value. This is an incredibly cheap currency. Anyone that's been on holiday to Japan can tell you how cheap it is. The value in the asymmetry remain outstanding. And we're at levels today where the bank of Japan and the Ministry of Finance have intervened repeatedly with deeds or with words to try and prop the yen up. And that's what creates that asymmetry, where you've hopefully got the downside underwritten from this point. And the upside is plain to see, because where the yen is today causes problems for everybody. It's stoking inflation in Japan because they have to import things like energy, and a weak yen makes that more expensive. And it's also difficult for the Chinese and for the Americans. They want the yen to be higher because a weak yen is making their currency stronger and it's making it difficult for their companies to compete with Japanese corporates.

Rory

Duncan, that's really helpful and feels like we've covered a deep dive on gold and the commodities and the yen as well, a little bit on the protection toolkit. But is there anything that you'd add in terms of how do you summarise Ruffer's positioning today and the outlook for the next six months, twelve months and beyond?

Duncan

I think the characterization of the ugly duckling portfolio is right. From Chinese equities to the yen, to inflation linked bonds, to all those protective toolkit elements that I mentioned. Performance is improving and with just one of the elements of the portfolio, the commodities firing in the last few weeks, performance has improved. We've got a very different approach to portfolio construction that will do much better than conventional portfolios if this world of financial repression and inflation volatility persists or comes to pass. If you don't yet believe in it.

Rory

Duncan, thank you very much for joining and thank you for listening. You can subscribe to refer radio, on the App Store, Spotify or wherever you get your podcasts. Past performance is not a guide to future performance the 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 in the UK and is registered as an investment adviser with the US Secure Securities Exchange Commission. The SEC registration does not imply a certain level of skill or training.
