PORTFOLIO MONTHLY REPORT – Sep / Oct 2017

Situation

I can well remember the drama of the UK being expelled from the Exchange Rate Mechanism (ERM) in 1992. This was when politics and central banking tried to manipulate the currency markets to keep the Pound within a trading range of the Deutschmark. Currency markets were viewed as a problem and rather than leaving it to importers and exporters and the currency markets to determine business the UK Government decided they knew better and fixed an exchange rate to the Deutschmark with a limited range either side. It was an open invitation to bet against the UK Government and some hedge fund managers like George Soros did so making billions from UK tax payers when it all turned into a disaster. Today central bankers are again trying to fix the market.

Since the financial crisis of 2008/09 central bankers have cut interest rates to almost zero and been buying bonds to "fix" the bond market. This Quantitative Easing (QE) as it is called is designed to lower long term interest rates. Short term rate are dropped to zero by the central banks and QE lowers longer term rates. This it is hoped will spur investment, growth and employment. But what it has done is encourage investors, pension and insurance funds to invest in risky assets in search of a return which the bond markets deny them. It has encouraged extreme valuations in some stocks and encouraged companies to raise money selling bonds and using that cash to buy back their own shares. That improves earnings per share the basis for director's bonuses !

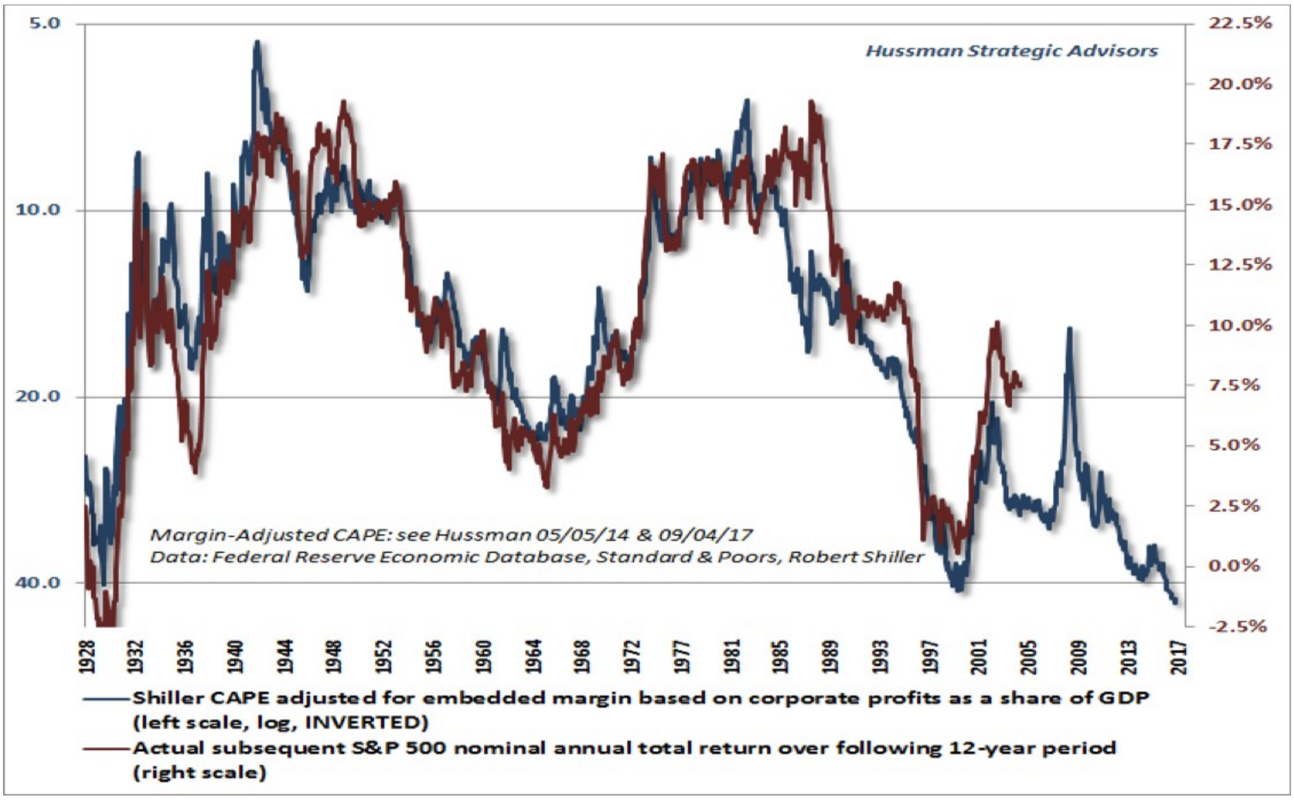
It is true that over the longer term investments in shares have outperformed bonds and cash however individual investors do not achieve the longer term averages but have a unique investment entry price. It is that price and of course the subsequent exit price which will determine their gain or loss. Currently the valuation of the US equity market is 175% above the normal (source Hussman) so investors now are taking a very high risk. This is further enhance by the growth in passive index tracking funds which buy the companies in the index and the more they rise the more the fund buys. Its the only business model I know where customers buy more and more as the price rises !

But the central banks are adding even more fuel to this fire because some are directly buying shares in companies. The Swiss National bank buys shares and is a major shareholder in Apple Inc. for example. The Japanese bank has been buying shares in index ETFs and now owns something like 5% of corporate Japan. The ECB has not yet bought shares but it has and continues to buy corporate bonds supporting companies such as Anheuser Busch, Nestle and Coca Cola. It is not clear to me why the European central bank feels supporting a global beer company, a Swiss food company or a USA soft drink company will encourage growth and employment in the Eurozone !!

Not only are the central banks supporting ever rising asset prices but normal price corrections are a thing of the past. Volatility is at all time lows and even modest corrections are not to be allowed. However now there are increasing concerns if they can unwind what they have done. The short answers is yes but there will be huge shocks in some places when it happens.

Take for example Tesla the electric car maker. Its share price has risen 66% over the last year and it is now more valuable than BMW but it sold only 76,000 cars in 2016 compared to BMWs 313,000. Tesla makes huge losses and has to raises cash by issuing shares so how will it operate in a normal investment market. There are many other examples as high valuations are across the board.

Chart below plots for the US market the adjusted price earnings against the actual total returns over the following 12 years. The fit is tight and it shows we are in the 1929 and 2000 zone with expected returns for the next 12 years below zero !



Of course we never know when the over bought position will revert to a more normal valuation so we need some patience. There will however certainly be some ideal moments to fully enter the market in the coming period and really benefit. This is what our managers aim to achieve.

Portfolio

Our main fund is an absolute return fund. This is where the manager invests in companies where he sees potential gains and then to balance this takes an opposite position in a similar company which he sees as likely to struggle. He and his team do this in several fields to build up a large and widely diversified portfolio aiming to benefit from the marginal gain. Its not going to race to the stars but at the same time gives us a high level of protection when valuations revert to their mean. The other funds have a similar strategy. To make gain while being very aware of the currently high valuations. We are also widely diversified.

It is sometime thought a wide range of funds will offer diversification however it depends. The most important determinate in investment performance is asset allocation. Investing in say the USA with ten different fund managers give no diversification. Furthermore many markets are correlated. What happens good or bad in the US significantly impacts markets in London ,Frankfurt, Hong Kong etc. Correlation is also currently high between stocks and bonds. Therefore we are diversified into many areas, sectors, styles and asset types to be able to navigate these central bank driven times.

Best wishes.

Tim 30 October 2017