Investment Letter: 12th March 2014

For most of us, the Cold War was the angst of our parents' generation. It is a case of bad irony that their fears, comprehensively unrealised, are now our reality.

Geopolitics swirl around us like the weather: the asset manager's discipline is to ask, what will plausibly change in terms of long run earnings streams, cash-flows, sovereign and corporate solvency.

Short of unmarked Russians launching into European territory, perhaps not much, and especially not much if the Western response is economic and eschews force. They know that, we know that. Hence all the current analogies to Putin being “a chess player”. Perhaps he is - but at what level is his paranoia on the Bobby Fischer scale?

The atmospheric conditions in relation to Emerging Markets are, at first glance, very poor. Russia is, after all, a brick in BRIC. Yet Russian equities, -11.2% cheaper than one month ago, already bear scars.

And when we think about the various topical ailments of Emerging Markets – Russian aggression, Nigerian graft, Argentinian fictions, Turkish xenophobia, Thai nepotism – they are varied and related only by the miserable governance of which each is in the thrall.

Being underweight Emerging Markets is now understood to be the consensus view and an active debating point within allocation meetings. The bottom up view is more nuanced; rare must be the equity portfolio that does not contain some element of dependence on countries with big populations, where urbanisation is still afoot and, in many cases (though not universally), demonstrates progressive demographics. Our own core approach to equity security selection states, as one of its governing limitations, is that we only invest in companies that “operate in multiple markets or are in the process of extending a strong domestic position internationally”. It follows that, when we look for long term growth, we look more to Delhi than Derby. It also follows that we would never want to be prematurely negative on Emerging Markets. Whilst our allocations are currently very light, we remain open minded.

Last week, Dr Paul Woolley visited our offices. We first knew Paul as a business partner of Jeremy Grantham, who is an unwitting mentor of our firm. Formerly of the IMF and Barings, Paul set up GMO's London office in 1987 (a memorable year in investment) worked there for 19 years and retired as chairman of GMO Europe in 2006. Paul has a bee in his bonnet about the years surrounding the Tech bubble. In those years, GMO, being a value manager, trailed the indices and eventually lost 40% of their assets under management as clients switched to what they perceived to be hotter hands.

Once all the underperformance had been recovered after the 2000 pop, the same investors came back to GMO: a classic tale of selling low, buying high.

Paul defines this, and the broad dysfunction of global investment markets as a Principal-Agent problem, a schema used elsewhere in economics. GMO, as the agent in this case, was forced to sell value stocks that he knew were great investment propositions. This drove them down much further below fair value, exacerbating the decline.

He extends this schema to encompass almost all aspects of discretionary investment. The dilemma is depicted as follows: the end investor does not know whether the hired firm is competent or diligent and therefore requires a benchmark to be used and tolerances negotiated. The replication of this rational behaviour results in crowding. Crowding results in a loss of diversity of view and amplification of trends. Trends extend to extreme levels and the reversals from these extremes created financial instability.

Paul argues that the problem is six times larger than it appears due to the presence of derivatives leveraging US$100trillion worth of notional assets six fold. Bank and hedge fund risk models are drawn from the Capital Asset Pricing Model (CAPM), a model which is informed by the Efficient Market Hypothesis (EMH), the orthodoxy which underpins modern understanding of asset markets.

Do ETFs and the passive industry help? Certainly not, they exacerbate the problems further: more herding, more replication, more over-extension.

His ideas have a resonance. The writer has long thought that the EMH is the most dismal thing to ever appear from the dismal scientists' book. Paul Woolley talks about the beauty of dysfunction in the way in which biologists will sometimes remark on the shapes or colours of cancers under the microscope.

Paul, and the various talented academics working with him, are trying to do nothing less than re-write the economic textbooks. Based on the three hours we were able to spend with him last week, we would say they have more than a fighting chance. For more information about the programme, follow this link:

http://www.lse.ac.uk/fmg/researchProgrammes/paulWoolleyCentre/home.aspx

As a partnership in a giant industry, all we can do is to refrain from worshipping false gods. Paul has a chance at breaking the idols and turning over the tables. If he does - and we wish him well - it will be a 21st Century understanding from London and Toulouse which will usurp Chicago's orthodoxy of the past 50 years.

James Spence
Managing Partner