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Economic Agent Orange

"I, however, place economy among the first and most important republican virtues, and public debt as the greatest of the dangers to be feared."

- Thomas Jefferson.

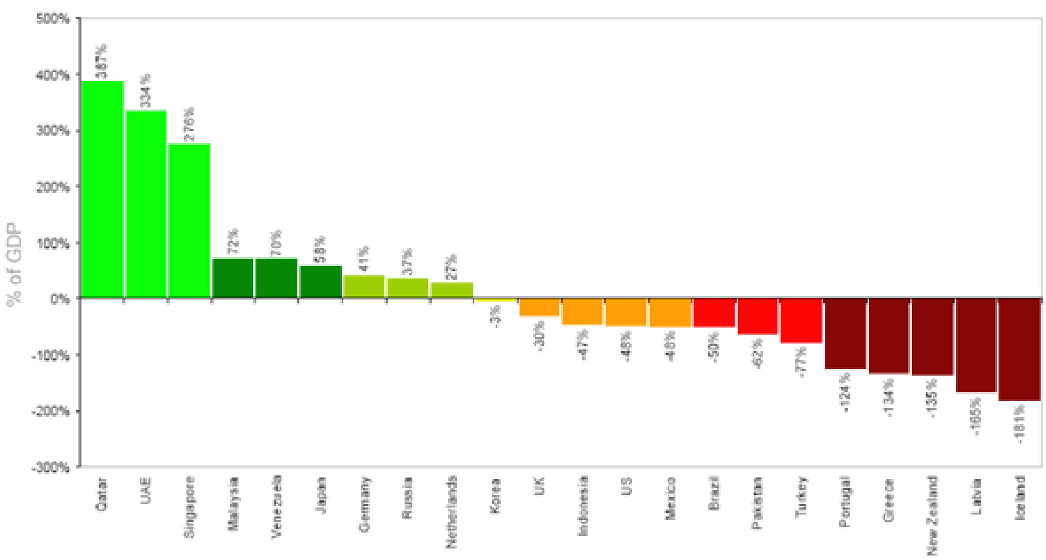
There are, crudely, three types of investment risk once one leaves the supposedly safe shores of cash deposits (and they, of course, come with their own very specific risk in the midst of a systemic banking crisis). One risk is that our investment incurs mark-to-market volatility, which may be pronounced. But market risk is a fact of investment life, and we just have to deal with it. One is inflation risk, the risk that our investment – however it performs in nominal terms – sees its real value eroded by inflation or currency depreciation. The third is that we incur a catastrophic loss of capital. As investors we can try and protect against risks 1 and 2, but we should ***really*** try to protect against risk 3, because encountering a sufficient number of risk 3 outcomes means 'Game Over' for our portfolio and for our capital. Welcome to the Euro zone debt and currency crisis, which manages to involve all of them.

There are also, crudely, two types of investor. There's the investor with skin in the game, with personal capital at risk. This investor could be a typical private investor, or it could be a hedge fund manager or boutique asset manager. Their portfolio is managed like a personal portfolio because typically it ***is*** a personal portfolio, albeit perhaps supplemented by third party client capital. Then there's the professional investor, likely having very little or no skin in the game beyond maintaining a related salary (and, of course, in pursuit of a hefty bonus). This investor could be a trader at an investment bank or he or she, most likely he – let us call him Economic Agent Orange – could be a traditional fund manager. When you're essentially playing with other people's money, you have a greater propensity to 'swing for the fences'. The pay-off is asymmetric. If you win, you win big. There's a reason why banks are so resistant to releasing information about bonus payments. If they were published in detail tomorrow, there'd be a revolution. But if you lose and lose big, you simply have to look for another job in the market, or perhaps you could try and do something more socially useful, like cleaning public toilets. That the second type of investor is now dominant in the market is a baleful development, because it is one of the factors behind the banking crisis to begin with. Give enough greedy people enough of other people's money to speculate with, and don't be surprised if accidents happen. Compare the fates of type 2 investors (we can call them, for want of a better phrase, banks) since 2007 with the fates of type 1 investors. As Hinde Capital point out, UK government support for Britain's banks amounts to £850 bn (plus £100 million for the cost of investment banking advice – what one might call an instance of super-cheeky rape of taxpayers). This figure breaks down into £280 bn in insurance cover for bank assets; £250 bn in guarantees of wholesale bank borrowing; a £200 bn indemnification of the Bank of England against losses for liquidity support; £76 bn in the purchase of RBS shares; and £40 bn in loans and funding to building societies and the financial compensation scheme. Oh yes, and now a loan of £7 bn or so to ~~British banks that lent to~~ Ireland. So on the one hand you have £857 bn in support for British banks. On the other hand you have the ***not one penny*** of taxpayers' money that has gone to, or been required by, hedge funds. That must be why continental Europe is so keen for (predominantly London-based) hedge funds to be more heavily regulated: because they're a clear threat to financial stability !

The Irish situation is now starting to change the whole dynamic of the credit crisis. Up until now, bond holders have, by and large, been made whole, despite their obvious failures to conduct sufficient credit analysis. (Put to one side the fact that the bond market is primarily an institutional market – that is, its main players are exclusively institutional, and by dint of being market professionals are meant to know what they're doing.) Somewhat rashly, the Irish government in September 2008 decided to guarantee the liabilities of its banks. In doing so, it inadvertently committed fiscal suicide. By essentially commingling Ireland's sovereign and corporate debt, it fatally polluted the entire country's credit profile. Cue the bailout. As Bloomberg reported last week, Allied Irish and Bank of Ireland senior debt is now starting to trade at distressed levels. This wasn't in the script. What about protecting all those vulnerable professional investors (you know – all those economic agents with no real skin in the game) ?

As you might expect after a wild and colossal party ends up with the building exploding, dealing with the immediate aftermath is somewhat chaotic and unplanned. Emergency measures are made up on the hoof. The status of various creditors to fundamentally dodgy entities is left unclear. Politicians are revealed to be rather poor communicators. (They have no skin in the game either, only an unjustified claim on vanity.) It is left to the market to sift the rubble. But at the risk of stating the blindingly obvious, bond investors – and it is now type I investors whom we address – should be beyond normally selective about assessing their allocations to credit markets. Very crudely, our advice would be: only lend your money – if indeed you want to lend it out at all – to those entities with an above average likelihood of being able to pay it back. Happily, as we have observed at regular intervals over the past year, there is one key metric that enables bond investors to assess sovereign counterparty credit risk, as shown in the chart below:

Net foreign assets of selected countries as % of GDP



Net foreign assets of selected countries (Source: IMF data, Stratton Street Capital LLP; data as at August 2009).

An assessment of different countries' net foreign assets (***not*** liabilities – some countries actually maintain fiscal discipline) as a percentage of their GDP shows a generalised geographic quality bias. The top ranked four countries above – Qatar, UAE, Singapore, Malaysia – are all Asian or Gulf-based. New Zealand apart, the bottom ranked four countries (Iceland, Latvia, Greece, Portugal) are all in what one might call the knackered West. Where as a bondholder would you rather invest ? Note, too, that your type 2 peers are all busily investing in supposedly riskless sovereign debt like that issued by the United States, the United Kingdom and Japan – countries which, by dint of their enormous debts, comprise the largest members of government bond indices. We might call this indexed approach – buying the most indebted markets simply because they're so big – nonsense on stilts. So be it. We will happily concentrate our bond investments in countries that are both higher yielding and generally improving sovereign credits, rather than those that are low yielding ***and*** effectively insolvent. 5 year US Treasuries currently yield 1.5%. 5 year UK Gilts currently yield about 2%. The New Capital Wealthy Nations Bond Fund, which invests on an unconstrained basis in bonds issued by those countries that the managers consider are best placed to pay that money back, and which has an average duration of roughly four years, currently yields roughly 7%. We pay our money and we make our choice. To investors into the grossly indebted government bond markets of the West, we say: good luck, and goodnight.

The Euro zone debt crisis also has an aspect of currency existentialism to it. Our friends at QB Asset Management recently cited the Eagles: "every form of refuge has its price". As QB suggest, risk is not in the asset, ***it's in the currency***. And as they point out, the only function of gold (beyond its utility as jewellery, which is obviously subjective, if aesthetically pleasing) is as a currency that competes with dollars, euros and yen, and all the rest. "Gold has been rising in paper money terms for ten years because wealth holders around the world are increasingly seeing it as a more stable currency than their local currencies.. Gold is a more stable currency than paper money because it is scarcer; annual demand for gold exceeds its production." Annual demand for paper money does not. The truly damning phrase should not be ***gold-bug*** but ***paper-bug***. Many investors and media commentators resolutely refuse to understand gold as real money. As with professional investors' inability to price sovereign debt rationally, this market anomaly is also a huge opportunity, and while it amuses and occasionally irritates us, it actually and ultimately suits us just fine.

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