PFP
Wealth Management

3 Windsor Court
Clarence Drive
Harrogate, HG1 2PE
01423 523311

Lion House
72-75 Red Lion Street
London, WC1R 4FP
020 7400 1860

www.pfpg.co.uk

10th January 2011

The first duty of intelligent men

A special, post-Christmas message:

"When I read about the evils of drinking, I gave up reading."

- Henny Youngman.

It is customary for asset managers to begin the year with a list of forecasts and predictions for the year ahead. Customary but a bit of a waste of both writer's and reader's time, unless the financiers in question have uniquely stumbled upon some formula for perfect foresight. City and Wall Street folk being what they are (amongst other things: simplistic, backward-looking and herd-following drones), such forecasts are as likely to provide value for contrarian purposes as for offering any kind of amazing insight into the otherwise unfathomable magic of the markets.

The US S&P 500 Index currently stands at roughly 1,275. Citigroup (bailed out bank), Goldman Sachs (bailed out bank), Bank of America (bailed out bank) and JP Morgan all, according to the FT's Lex column, have targets between 1,400 and 1,450 for the S&P 500 this year. So far, so predictable. It may actually be compulsory for Wall Street banks to be bullish about the market. It may have been a condition for getting bailed out in the first instance. Robert Shiller, author of 'Irrational Exuberance' and Yale economics professor, also has a target – in his case, of 1,430, bang in line with the rest of Wall Street. The difference, as Lex points out, is that Shiller's target is for the year 2020.

One obvious response to these price targets is to ask: if the financial heavyweights in question were so good that the only thing standing between them and bankruptcy or market failure was the US government, why on earth should anyone take their forecasts about anything seriously ? Did they foresee and predict their own need to be gifted emergency funds from the US taxpayer ?[1] A more nuanced response is simply to acknowledge that we live in a fallen world, monetarily speaking, and that for as long as we are faced with unbacked paper money and fractional reserve banking, the global financial system will forever be prone to crises of confidence, bank runs, greedy bankers getting away with murder, and an inherent bias toward inflationism.

[1] It's a fair cop. There's no need continually to pick on selfish and idiotic bankers. But given the support this writer and taxpayer, and millions like him, is involuntarily extending to those selfish and idiotic bankers, who now feel free to reward themselves with money that isn't realistically theirs to begin with, then picking on selfish and idiotic bankers is as easy and amusing as shooting dead selfish and idiotic bankers in a selfish and idiotic banker barrel.

So we are where we are, even if the view isn't especially pretty. Whether Shiller or Wall Street turns out to be closer to the truth in terms of US stock market returns in 2011 is in any case somewhat academic, particularly for non-US investors. In the bigger picture, the game is being rigged, and markets are being juiced with liquidity that it didn't cost anything to create. In that sense, it's rational to be bullish: inflation is good for nominal market returns. We are, of course, interested in the business of generating meaningful real returns – so having a government that continually lies about and arbitrarily changes its measure of inflation isn't extraordinarily helpful.

Nevertheless. One of the many attractions of working for an independent wealth management firm is that one is privy to all sorts of intelligent and stimulating commentary from other independently minded managers. Tied and otherwise conflicted asset managers may of course read the same commentary – but they can't invest into the associated funds. We have been especially privileged over the last year to receive commentary from two firms in particular given the ability of their principals to convey complex monetary and financial arguments with a superb degree of articulacy, wit and style.

Tony Deden, manager of the Edelweiss Fund, makes the following point with reference to the fund's performance:

"..our results in the short-term should be attributed not to any special ability on our part but rather to three distinct and indisputable factors:

a) The ongoing slow, often volatile but nonetheless certain depreciation of paper monies against assets such as precious metals,
b) The rise in the prices of certain financial assets fuelled by the credit creation that is at work, and
c) The reflection of genuine and honest entrepreneurial activity."

Moving on to the larger macro-economic perspective, Tony writes:

"..the state has crossed the Rubicon in its commitment to a policy of inflationism. The unavoidable and certain end result will be an even greater crisis than the world has yet seen. Without a financial catharsis, massive sovereign bankruptcies and a return to free-market principles, all the ridiculous ideas of fomenting growth by inflationism will end up in tears. George Orwell was right. "*We have now sunk to a depth*," he wrote, "*at which the restatement of the obvious is the first duty of intelligent men*."

Paul Brodsky and Lee Quaintance of QB Asset Management make a fair but very subtle point in relation to one of the few defences available against fiat money and associated political currency debauchery, namely gold:

"The fact is that gold ***should be*** off investor menus. Rather, it should be amassed by ***savers*** [my emphasis] who convert some portion of their paper media of exchange for it. This is how gold was treated by the ancients and by our great grandparents, and it is how gold is being treated today by virtually all governments and people in economies with less developed financial systems. Western societies are quite sophisticated investors but quite unsophisticated savers. [With deposit rates effectively at zero, courtesy of the people's friends, the bankers, in league with their friends in central banks, that's hardly surprising.] The risk in the West is that we believe our own monetary invincibility, seemingly based on a sense of intellectual superiority, against all signals to the contrary."

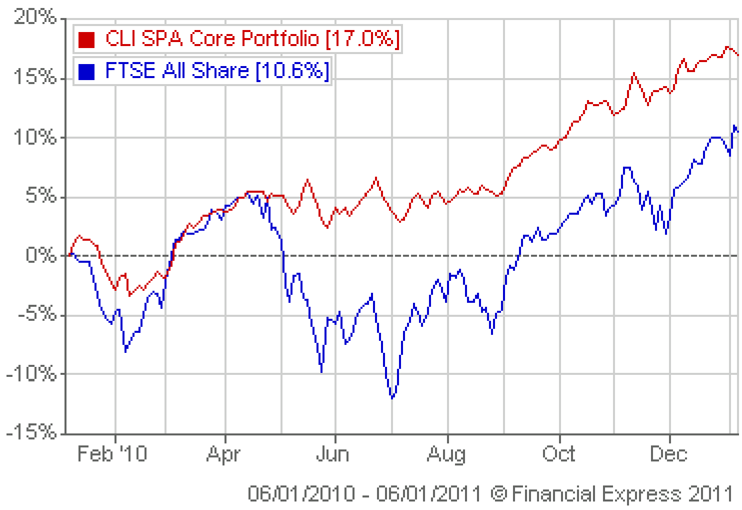
Actually, this author reserves the right to make one or two predictions for the year ahead. One of them is a slam dunk, and one of them is possibly a high probability outcome.

Prediction # 1: Politicians facing the terminal decline of the current and untenable monetary system will continue to make up policy on the hoof in a doomed attempt to deter the inevitable and rescue the unsalvageable. Expect more stupid things out of Europe and the US for a kick-off.

Prediction # 2: Central banks – especially the Bank of England – will watch in horror as inflationary pressure builds while they are effectively powerless to do anything about it. This is, of course, the same inflationary pressure that was entirely predictable once policy rates went to circa zero across the world amid an orgy of monetary stimulus. They will be damned if they do and damned if they don't. If they don't do anything as bold as raising policy rates, understandable given the fragility of the banking system and the economy and the typical mortgage holder, then holders of things like Gilts may well vote with their feet. Look out below. If they do do anything as bold as raising policy rates, then holders of things like Gilts may well vote with their feet. Look out below. In short, 2011 could be the crunch year for the Great Bond Bull. We will be celebrating the start of 2011 by not owning Gilts, and favouring higher yielding and, we think, sounder government bond markets elsewhere.

So high quality bonds, silver and gold. The two missing ingredients: high quality, high yielding and defensive equities, and high quality absolute return managers. Longstanding readers may twig that this is exactly how we have been positioned for roughly the last decade. But we don't feel under any pressure to change tack simply in response to a change in the date. Different year, but same circus.

How did this approach work last year ? Our client portfolios are bespoke. But we do manage a collective fund administered by Canada Life International, the CLI Spa Core Portfolio. Its intention is to mirror what we do within a "typical client" portfolio, inasmuch as we have one. 2010 performance is shown below. The comparison with the FTSE All Share is entirely arbitrary, given the multi-asset nature of our fund, and has no purpose other than to show our own performance in a more favourable light.



Other offshore insurance funds are, of course, available.

Tim Price
Director of Investment
PFP Wealth Management
10th January 2011.

Email: tim.price@pfpg.co.uk Weblog: http://thepriceofeverything.typepad.com

Group homepage: http://www.pfpg.co.uk

Bloomberg homepage: PFPG <GO>