

Smart ideas about wealth

Back to the Future

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Once upon a time in the late sixties there was a central bank in a big country called The United States (US). The US was run by a right-wing President whom a lot of people didn't like. This President's country was involved in a war in a country called Viet Nam, with which a vocal minority of the people in his country didn't agree. The President decided to do some nice things for his people, to take their mind off the war and make their lives better – otherwise known as an ambitious social programme. Instead of taking a bit more in taxes from the rich people to pay for the war and the ambitious social programme, the President decided to borrow the money he needed. After a few years the President owed a lot of money.

The President makes his own rules

Eventually the President owed so much money that the other countries decided that they wanted more of his money in return for their goods and services, just in case the US couldn't pay the interest on the money it owed. The President, through his own bank, kept buying up his own money to make it worth more but the other countries just kept asking for more and more in return for their goods and services. The other countries weren't too worried though because the President's money was underpinned by a rare metal called gold. But because the President needed to create more money than he had gold to support it, he decided to forget about the need to have enough gold and just printed the money anyway. From this point the President could print as much money as he needed and spend as much as he wanted on whatever he liked.

Boom times on 'the strap'

After a time there was a lot of the President's money flowing around the world seeking goods and services (known as excess liquidity), and this allowed the other countries to charge more and more for their goods and services. Initially everything was great, with things like houses and company shares shooting up in value. By the early seventies there had been twenty years of strong global growth, which means everyone had jobs, things like houses kept going up in value and the prices of day to day things didn't go up too quickly. Everyone thought that the good times wouldn't end because the government could always make sure everyone had a job and the banks would always lend people money.

Things aren't quite what they seem

The stockmarket, which is where companies obtain money to help them start and grow, had grown a lot since the sixties – by over 262%, after taking into account a nasty thing called inflation. Although growth was lower in the sixties, at 87%, it was still welcome by investors. But a small number of wise people who liked numbers, who were called economists and financial analysts, realised that the increase in the value of stockmarkets in the late sixties had occurred for a less desirable reason than that which had caused the rise in the fifties. In the fifties share prices in companies rose a lot because most companies were increasing the profits they were earning (known as 'earnings growth'), so investors were happy to pay more for these bigger profits. In the late sixties companies didn't earn as much money, but everyone was still happy to pay a lot for the companies' profits because they had lots of money to invest and they could borrow even more.

Smart ideas about wealth

Bonds start to fall

Some people didn't like the thought of investing in companies to get a share of the profits, so instead they decided to lend companies and governments money in return for a fixed regular payment called 'interest'. These loans were called 'bonds'. The problem was that as the years went by from the mid sixties, the regular interest payments were worth less and less because the cost of everything was starting to increase. This meant that companies and governments had to start offering higher and higher interest payments to persuade investors to lend them new money. Investors who had already lent to companies and governments by investing in bonds at the lower rates of interest started to see the capital values of these bonds fall until they produced the same amount of interest as new bonds would provide.

Enter the Gurus and conglomerates

At about this time a number of companies were created by people who thought they were smarter than everyone else. These smart people were otherwise known as 'Gurus', after the name given to wise men in India. The Gurus could see that there were a lot of investors who wanted to invest in the profits of companies, so they set about creating something called a conglomerate – which is a company which buys lots of other companies with assets and profits. The conglomerates then made these profits seem larger than they were by rearranging the numbers in the accounts (otherwise known as creative accounting). Companies like Lonrho, Trafalgar House and Slater Walker in the UK and Automatic Sprinkler, Textron and ITT in the US were busy buying up smaller companies so they could in turn attract more money from people who wanted to share in these rising profits. No one thought it mattered that the Gurus didn't know anything about the businesses they were buying or that they were all different from each other, because it seemed that the profits of the Gurus' businesses kept rising and as a consequence so did the value of their shares.

Go go funds offer quick riches

Whereas most investors in companies in the fifties and early sixties had been pension funds and insurance companies, which are big organisations which look after ordinary people's money, in the late sixties and early seventies people could invest in something called a unit trust (in the US this was called a mutual fund). These trusts in turn invested into a number of companies, on the say so of bright people called fund managers. Some of these funds produced very good returns compared to the stockmarket as a whole and more and more people put their money in these funds – which were known as 'go go funds' in the UK and 'gunslingers' in the US, due to their aggressive approach to investing. One of the biggest go go funds, Slater Walker, was actually a conglomerate which had decided to turn itself into an investment bank and it benefited from lots of changes to the banking rules which meant banks could do much more risky things than they had previously been allowed to do.

The tide starts to turn

For people investing in the profits of companies things continued as they had done until the price of one particular thing – oil – went up a lot in the early seventies following a war in the middle east. The rise in the price of oil, together with the rise in the price of everything else, started to get out of control and caused a rapid increase in a nasty thing called inflation. This led the world's central banks to start being a bit meaner with their money and charging a lot more for it. As a consequence people started losing their jobs, companies made less of everything and generally everyone was very sad and down in the dumps. In fact inflation got so high it was renamed 'stagflation', which means that although prices were continually rising, no one had much money actually to buy anything. The value of investments in companies' profits, as measured by the price that investors were prepared to pay for them, kept falling until they were worth less in 1974 than they had been in 1965.

Smart ideas about wealth

The Gurus running conglomerates found that their shares kept falling so they couldn't buy any more companies and the profits of their underlying companies were worth less and less, thus reducing the value of the conglomerate even further. By this time no-one believed the Gurus' assertion that they were extraordinary managers who could generate great returns by buying up a rag-bag of industrial assets and wrapping them all up within a single company.

Investors in go go funds and gunslingers saw their money fall in value a lot in a short space of time, so no one wanted to invest any more and existing investors couldn't get much of their money back. A number of the smaller banks, which were running go go funds, had to be rescued by the UK government 'lifeboat', which meant the pensions and insurance companies had to buy them and sort out the mess. Go go funds and gunslingers eventually disappeared as most funds closed or merged with less risky funds.

It would be over ten years before ordinary people started to feel brave enough to start investing in companies or lending companies and governments money. Of course by the time they did that, they had missed out on a rise in the share prices of those companies which was even more spectacular than the fall. The government of the day decided on a great idea – to sell the public companies that they already owned – through a process called privatisation, but that's another story!

It couldn't happen again – could it?

At Bloomsbury we don't think we are smart enough to predict the future behaviour of stockmarkets or economies and we don't think that anyone else is either. However, there are interesting parallels between what happened in the seventies and what is unfolding today, which we would do well to consider.

An unpopular right-wing US president is spending money he doesn't have on a war which he is widely considered to be unlikely to win. The world is awash with cheap money, much lent by banks, which has pushed up the price of financial assets, particularly property and to a lesser extent shares, to unprecedented levels. Inflation is starting to pick up and world growth is starting to slow. Unemployment is starting to rise, as is the number of personal bankruptcies.

In 1965 US 10-year bonds were yielding 4.2% at their lowest point. The yield rose steadily to reach a high of 12.2% in 1980, causing the capital value of conventional gilts virtually to collapse. Currently US 10-year bonds are yielding about 5% and UK 10-year gilts are yielding about 4.6%, with lots of demand from pension funds looking to match their liabilities. Interest rates are starting to rise in response to rising inflation.

Instead of Gurus running conglomerates we have private equity houses using cheap borrowed money to buy public companies and taking them private. These so-called 'inefficient' companies, about which the private equity people know little, are then loaded with debt to allow the private equity people to award themselves large dividends, leaving someone else to deal with the consequences of possible falling profits having to service increasing interest charges.

Instead of go go funds and gunslingers we have hedge fund managers promising that they can find superior returns by taking big bets and aggressively trading in various markets, all the while charging investors handsomely for the privilege. No one knows what these managers are doing, the risks they are taking or how much debt they are leveraging to obtain exposure. Recently Amaranth, one of the largest hedge funds, lost almost \$3bn of its clients' assets when a bet on gas futures went the wrong way. The fact that Amaranth was betting on gas prices, rather than investing in line with its originally stated strategy of long bond arbitrage, may have come as a surprise to most of the investors in the fund.

Smart ideas about wealth

It is highly unlikely that private equity and hedge funds will follow the same fate of conglomerates and go go funds in the seventies, and bond yields may not rise much, thus avoiding a collapse in value as a result. However, the possibility is always there that we may be entering a similar environment to that which existed in the early seventies. At Bloomsbury we don't think anyone is smart enough to predict either future economic conditions or the direction of investment markets consistently. Our rules for financial success are based on a tried and trusted academic approach which takes the emotion out of investing:


- after allocating sufficient cash to your short term liabilities, hold a fully diversified portfolio comprising bonds and equities according to your personal risk capacity;
- avoid hedge funds and private equity unless either it is your line of business, or you have an interest in the company/sector and it only represents a very small part of your wealth;
- split bonds equally between short-dated global bonds (which have much lower volatility than long gilts) and index-linked gilts to minimise the effect of increasing inflation and rising bond yields;
- split equities between UK and international index funds;
- allocate some of the UK and international equity exposure to small capitalisation and value asset class funds, and some of the international equity to emerging markets, which studies show have a higher return profile due to their higher risk;
- rebalance the portfolio back to the model allocation whenever any holding deviates significantly (between 10-20% depending on portfolio size) from its original allocation. This ensures that the portfolio maintains the same risk profile, regardless of what markets are doing, and allows you to capture the returns which are there for the taking.

There are no certainties in life, except perhaps death and taxes, but when markets prove challenging and difficult economic conditions arise, one could do a lot worse than follow our disciplined approach. There are those who learn from history and those who don't, but Bloomsbury clients can sleep well knowing that their capital is positioned well whatever the future holds.

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